92D CONGRESS, 1st Session } HOUSE OF REPRESENTATIVES { REPORT No. 92-533

THE REVENUE ACT OF 1971

SEPTEMBER 29, 1971.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. MILLS of Arkansas, from the Committee on Ways and Means, submitted the following

REPORT

WITH DISSENTING VIEWS

[To accompany H.R. 10947, to provide a job development investment credit, to reduce individual income taxes, to reduce certain excise taxes, and for other purposes]

The Committee on Ways and Means, to whom was referred the bill (H.R. 10947) to provide a job development investment credit, to reduce individual income taxes, to reduce certain excise taxes, and for other purposes, having considered the same, report favorably thereon without amendment and recommend that the bill do pass.

I. SUMMARY

The Revenue Bill of 1971 provides a balanced program of tax reductions for individuals and tax incentives for business. This bill is designed to—

- put our present lagging economy on the high growth path.
- increase the number of jobs and diminish the high unemployment rate.
- relieve the hardships imposed by inflation on those with modest incomes.
- provide a rational system of tax incentives to aid in the modernization of our productive facilities.
- increase our exports and improve our balance of payments.

It is believed that this bill will attain these objectives by working in cooperation with other governmental actions, including the present wage-price freeze (and the anticipated incomes policy which the President has announced will follow), together with other actions taken to meet the dollar crisis abroad and the commitments of the administration to reduce government spending by approximately $5 billion.

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The bill is expected to reduce tax liabilities about $1.7 billion in the calendar year 1971, $7.8 billion in 1972, and $6.0 billion in 1973. The principal actions provided by this bill to aid in the attainment of the objectives set forth above are:

1. A 7-percent job development investment credit is provided. The credit is generally effective on August 15 (although also effective with respect to earlier deliveries where orders were placed after the end of March). At the same time, however, the liberal depreciation system (Asset Depreciation Range) provided by administrative action in January of this year has been modified somewhat to remove an element providing additional depreciation for assets in the first year of their use (referred to as the first-year convention). The investment credit is expected to make from $1.5 billion in 1971 to $3.9 billion in 1973 available to businesses which expand and modernize their equipment and facilities. The modification in the depreciation system (ADR) offsets the initial revenue impact of the investment credit by forestalling tax reductions which would otherwise occur as a result of administrative action. These reductions which are forestalled would have amounted to $2.1 billion in 1971, decreasing over later years to $1.7 billion in 1972 and $1.5 billion in 1973.

2. Significant individual income tax reductions are provided for those who have been hardest hit by inflation and where the greatest impact on increased consumer spending can be anticipated. Under your committee's bill these reductions begin this year. For 1971 all personal exemptions are increased from $650 to $700 effective for one-half the year ($675 for the entire year). In addition, the minimum standard deduction is modified to provide additional relief in the lower income tax brackets in 1971. These changes will provide an immediate tax reduction this year of $1.4 billion. For 1972 and subsequent years, your committee's bill further increases all personal exemptions to $750. It also increases the minimum standard deduction, or low-income allowance, from $1,000 to $1,300 and further increases the percentage standard deduction to 15 percent (already scheduled to go to 14 percent with a $2,000 ceiling in 1972).

This latter action gives assurance that the individual income tax will not be imposed below the poverty level (taking into account anticipated poverty levels for 1972). These individual income tax reductions for 1972 are expected to amount to approximately $3.2 billion. This is in addition to a reduction of $2.7 billion (compared to 1971 levels) which occurs automatically in 1972 as a result of the Tax Reform Act of 1969.

3. The 7-percent manufacturers excise tax on passenger automobiles is repealed effective with the date of enactment of this bill. For those taxes paid for the period back to August 15, 1971, consumer refunds or floor stocks refunds are provided. In addition, your committee also repeals the 10-percent excise tax on light-duty trucks (those weighing 10,000 pounds or less gross vehicle weight) with consumer refunds or floor stocks refunds for the period after September 22, 1971. These light

trucks, to a substantial degree, are used as a means of personal transportation. These tax cuts are expected to reduce tax liabilities by $900 million in the calendar year 1971, $2.6 billion in 1972, and $2.3 billion in 1973.

4. Tax deferral is provided for export income of domestic international sales corporations (DISC's) effective with the calendar year 1972. This tax deferral is to be available, however, for export income in the current year only to the extent of 25 percent of a company's average level of export income in the years 1968 through 1970 plus any of its current export income over this average level. This is expected to result in reductions in tax liabilities of $100 million in 1972 and $200 million in 1973.

5. The bill also makes a series of structural improvements in the tax law, including some which are clarifications of existing law. These relate to a limitation in certain cases on the standard deduction and personal exemption of individuals receiving trust income, a limitation on carryovers of unused credits and capital losses in the case of certain changes in ownership, amortization of expenditures for on-the-job training and for child care centers, a revision in the definition of a net lease, a modification in the application of the farm loss provision in the case of subchapter S corporations, a modification in the case of capital gain distributions of accumulation trusts, a provision that income from the Virgin Islands is not to be treated as Western Hemisphere Trade Corporation income, a clarification of the application of the minimum tax to foreign capital gains on which little or no foreign tax is imposed and a clarification of the right of taxpayers to bring cases into courts under tax treaty provisions.

II. REASONS FOR THE BILL

Your committee believes that this bill is necessary because the performance of the economy in recent months has been unsatisfactory. The growth in our gross national product has been small, unemployment has remained too high, and capital goods expenditures have hardly grown at all. Despite these factors, which would usually point toward deflation, we have been unable to shake the persistent inflationary trend of prices. All this has been compounded by our serious adverse balance of trade and the accompanying crisis in the position of the dollar abroad.

In the first half of 1971—after adjustment for growth delayed by the General Motors strike of last year and for price increases—the economy grew at a real rate of only about 3 percent. A major—but not the only—factor contributing to this inadequate rate of growth has been an abnormally low rate of capital spending. The latest survey indicates an increase of only slightly more than 2 percent in plant and equipment spending this year. In real terms, after adjustment for inflation, this actually represents a decline from last year.

Unemployment levels also have remained too high. The unemployment rate reached 6.2 percent in May 1971 and, after a modest decline in June and July, again went over the 6-percent level in August. Accordingly, the unemployment rate has shown no inclination to return to the 4-percent level which represents the rate generally viewed as the full employment rate. Concern over unemployment, in turn, has caused individuals to be more conservative in their spending, sending the consumer savings rate to the very high level of 8.2 percent. This, interacting with low capital expenditures by business, has contributed to the high unemployment rate.

Despite the unsatisfactory levels of employment and production, prices have continued to rise. Over half of the increase in the gross national product in the first six months of this year, for example, is attributable to price increases. Prices have continued to rise at all too fast a rate. Over the last twelve months (from July to July) the consumer price index rose 4.4 percent and the wholesale price index 3.3 percent. And in the first seven months of this year alone, the wholesale price index rose 3.2 percent, foreshadowing further rises in the consumer price index.

Our balance-of-payments position has also deteriorated badly. In the second quarter of this year, our balance-of-payments deficit, both on a net liquidity basis and on an official reserve transaction basis, ran at an annual rate of about $23 billion. We no longer have a trade surplus on goods and services. Instead of surpluses ranging from $7.1 billion in 1965, $2 billion in 1969 and $3.6 billion in 1970, we had a deficit of $22 million in the second quarter of this year. This culminated in the dollar crisis in August, when the United States terminated the convertibility of dollars into gold. These difficulties in our balance of payments are, of course, a result of a number of complex factors including inflation at home and discriminatory trade practices abroad. But they are also a result of the fact that our tax policies do not adequately encourage investment in more modern and efficient machinery which would enable our businessmen to compete more effectively in foreign markets.

In designing a tax program to ameliorate these serious economic problems, your committee has been guided by certain broad considerations. It has sought a balanced program which will provide fair relief to both individuals and business. In this your committee has been guided, not only by the need to adopt a proposal which is fair, but also by the fact that the restoration of sound and vigorous economic conditions requires the stimulation of both consumption by individuals and investment by business.

In view of the current economic situation, your committee concluded that the tax reductions and incentives should begin to take effect as soon as possible. They must be large enough to stimulate the economy and yet not so large that they create a new wave of inflationary pressure. It is in this setting that your committee provided the level and type of tax reductions included in this bill in the belief that they will be sufficient to increase the Nation's output and provide additional jobs, yet not add to inflation. As output increases and the economy moves closer to desired high-income levels, unit costs can be expected to decline and productivity increase. Despite this, however, without two closely related developments, it is doubtful that your committee would have been able to construct a tax reduction bill which did not have a serious inflationary impact. First, the administration has imposed a wage-price freeze and has indicated that an adequate form of inflation control will be maintained after November 13 when the wage-price freeze expires. Second, the administration has announced its intention to cut Federal expenditures for fiscal year 1972 by $4.6 to $5 billion below previously planned levels. Such expenditure control is an essential part of the program to check inflation and your committee believes that it is essential that these expenditure reductions be achieved.

H.R. 10947 provides substantial tax reductions to individuals and substantial tax incentives to business in order to bolster the economy. Assuming prompt enactment of this bill, significant tax reduction will be provided for 1971 with the tax reduction reaching a total of $7.8 billion for calendar year 1972. When combined with the $2.7 billion of tax reduction automatically to take effect in calendar year 1972 over 1971 under the provisions of the 1969 Tax Reform Act, the tax reduction provided in calendar year 1972 will total $10.5 billion over 1971.

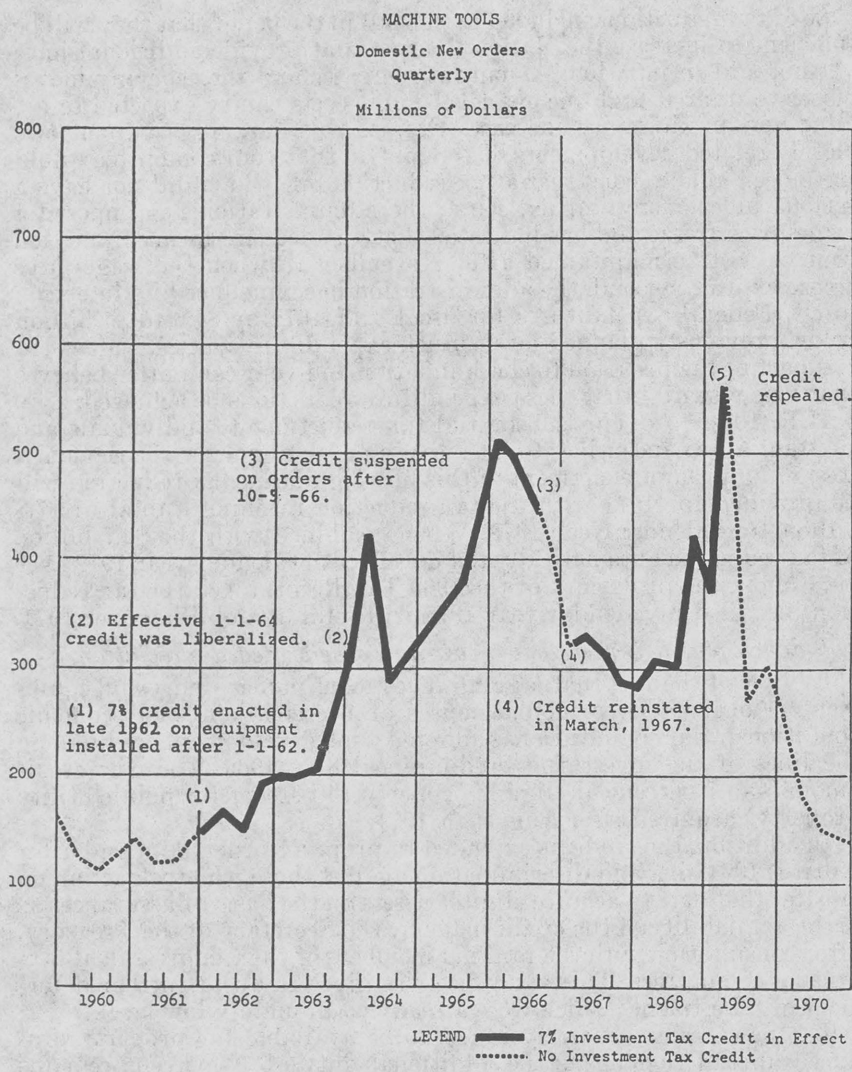
Job development investment credit and accelerated depreciation

In view of the fact that lagging investment in machinery and equipment is one of the principal causes of present depressed economic conditions, your committee has adopted a job development credit along the lines of the investment credit repealed in 1969. The new credit amounts to 7 percent of eligible property (4 percent for public utility property) acquired after August 15, 1971.

In addition, the credit is extended to property ordered on and after April 1, 1971, to avoid discrimination against those who took action on or after that date to acquire eligible assets on the basis of assurances as to the availability of the credit made by the Secretary of the Treasury, after consultation with the ranking members of the Congressional tax-writing committees. This assurance was given to avoid further deferment of investments which were already at an unduly low level.

The new credit generally is not to be available for property produced abroad so long as the additional duty of 10 percent remains in effect. However, the bill grants the President authority during this period to make the credit available for specified articles of foreign-produced property where this is in the public interest.

The new credit is expected to bolster the economy and create additional jobs by encouraging expenditures on machinery and equipment which have been sagging badly. In this connection, attention is called to the following chart which shows the close correlation between machinery orders and availability of the investment credit.



Moreover, over the long run, the job development credit will be of material assistance in combating inflation. An increased flow of goods into the market is the best long-run assurance we can have of keeping prices down.

Finally, by making our productive facilities more efficient the new credit will help our exporters to compete for foreign markets and improve our balance of payments.

Your committee concluded that a flat rate credit of 7 percent was preferable to a credit which initially was larger and then in later years was smaller. It believed that a varying credit would be inconsistent with the basic objective of providing an incentive for adequate investment on a long-term basis. Moreover, a credit which is scheduled to drop abruptly after a period of operation would be likely to encourage investments in the earlier period at the expense of the later period. In addition, a varying credit would be likely to produce inequitable results. Businesses needing assets which can be produced only after a long lead time would frequently not be able to qualify for the higher credit because they would not be able to receive the asset in time. Similarly, the mere fact that the acquisition of an asset was delayed, perhaps because of production difficulties, could reduce the amount of the credit.

Your committee also reexamined the system of depreciation introduced by the Treasury Department by administrative action in 1971—The Asset Depreciation Range System (ADR)—in light of the provision adopting the job development credit. It concluded that the combined stimulative effect of these two measures was too great. As a result, this bill removes the first year convention under ADR which, in effect, treats all property placed in service during a year the same as if it were placed in service on the first day of the second quarter of the year for depreciation purposes. This action, in effect, restores the prior convention under which property, in effect, was considered placed in service at the middle of the year for purposes of depreciation.

The combined effect of this change and the adoption of the job development credit is to increase business taxes by an estimated $600 million in calendar year 1971 and to decrease business taxes by an estimated $1.9 billion in calendar year 1972 and $2.4 billion in calendar year 1973. However, since the tax effect of withdrawing the three-quarter year rule provided by ADR becomes substantially less in later years, business firms will eventually benefit from the full amount of the job development credit with only a modest offset for the withdrawal of benefits resulting from elimination of the first-year convention provided by ADR.

Tax reduction for individuals

Individuals receive a substantial share of the total tax benefits provided by the bill. It was believed that this is desirable because of the need to increase consumption and to aid low-income individuals who have been severely burdened by inflation.

In calendar year 1972, $3.2 billion (or 41 percent) of the total tax reduction provided by the bill will accrue to individuals through liberalization of exemptions and the standard deduction. When the tax cuts provided by the bill are combined with the automatic tax cuts already scheduled to take effect in 1972, individuals will receive a reduction of $5.9 billion from these provisions, or 56 percent of the total.

This effect is secured in part by accelerating the effective dates of tax relief automatically scheduled to take effect under the provisions of the 1969 Tax Reform Act. Support for accelerating the tax reductions for individuals scheduled under the 1969 Act—to make them effective at an earlier date—has been practically universal.

In view of currently depressed economic conditions, your committee believed it was desirable to begin the tax relief to individuals as early as possible in 1971, rather than to wait until 1972. Accordingly, this bill speeds up the effective dates of two tax relief measures of the 1969 Act to make them effective in calendar year 1971. First, it increases the exemption level from $650 to $700 effective July 1, 1971 (this, in effect, moves the personal exemption for the entire year of 1971 to $675). Second, it provides that the full low-income allowance of $1,050 will be available in 1971 without reduction of the allowance where income exceeds nontaxable levels. This is achieved by eliminating the so-called phase-out provision which operated to reduce the low-income allowance where income in excess of specified amounts was received. This was scheduled for elimination in 1972 under the 1969 Act.

To insure that this tax relief is received promptly, the withholding rates are adjusted downward effective November 15, 1971, to reflect the reduced tax liability.

For 1972, your committee's bill provides three changes which grant substantial tax relief to individuals. First, the $750 personal exemption level, which under the 1969 Act was to be effective on January 1, 1973, is made effective as of January 1, 1972. Second, the percentage standard deduction is increased to 15 percent of adjusted gross income with a $2,000 ceiling in 1972. Under the 1969 Act, the maximum percentage standard deduction was to be 14 percent of adjusted gross income in 1972 and was not to reach the 15-percent rate until 1973.

A third change effective for 1972 increases the low-income allowance from the $1,000 level that would otherwise have applied in that year to $1,300. This change in the low-income allowance represents a liberalization increasing the level of the allowance provided by the 1969 Act. This change recognizes that, as a result of inflation, the previous level of the low-income allowance was not sufficient to achieve its purpose of preventing hardship for low-income people living at, or near, the poverty level.

The effect of the increased low-income allowance together with the higher personal exemption will be to remove Federal tax liability for individuals and families living below the poverty level. Of course, all individual income tax payers will benefit from the exemption increases. About 25 million tax returns will also benefit from the increased low-income allowance and the combination of the low-income allowance and exemption increases will make 2.8 million tax returns nontaxable.

Repeal of excise tax on autos and small trucks

Consumers are given additional relief and further stimulus is provided for production in an important industry by repeal of the 7-percent manufacturers tax on automobiles effective August 16, 1971. In addition, the 10-percent tax on small trucks with a gross vehicle weight of 10,000 lbs. or less is eliminated, effective September 23, 1971. Provision is made for tax refunds on items sold on or after the effective dates referred to.

Repeal of the excise tax on automobiles will do much to directly create additional jobs and stimulate consumer spending. Repeal of the excise tax on automobiles is expected to reduce car prices on the average by about $200 per car. The administration has estimated that this reduction will result in 600,000 additional domestic automobile sales and 150,000 additional jobs, not counting dealer employees.

Repeal of the tax on autos also contributes to the equity of our tax system. The Congress has already recognized that this tax should not be a permanent part of our tax system by enacting legislation providing for the periodic reduction of this tax until it is eliminated on January 1, 1982. The action taken in this bill continues the trend begun in 1965 to repeal excise taxes which place discriminatory tax burdens on the consumers and producers of the taxed products.

Automobile manufacturers have given assurances that the tax reductions will be passed on to consumers in the form of reduced prices. To insure that this occurs, your committee requests the Council of Economic Advisers to make a study to determine whether the tax reductions are, in fact, passed on to consumers.

The tax on small trucks is repealed in view of the fact that these small trucks are used to a considerable extent by farmers and other individuals for the same purposes as passenger automobiles.

Domestic International Sales Corporation (DISC)

To provide tax incentives for U.S. firms to increase their exports, your committee has provided tax deferral for export-related profits. This tax deferral will be granted on profits so long as they are retained in a new type of U.S. corporation known as a Domestic International Sales Corporation or a "DISC." The requirements for qualification as a DISC in general are that substantially all of the corporation's gross receipts and assets must be export related. When the profits of the DISC are distributed to its shareholders as dividends or are otherwise realized by them as income, they are taxable to them in full at that time.

Under the provision, a parent corporation will be allowed to sell its export products to the DISC at prices which permit the DISC to earn up to the greater of 4 percent on sales or 50 percent of the combined income from the manufacturing and selling of the exports (plus, an amount equal to 10 percent of export promotion expenses and 10 percent of half of shipping expenses incurred from shipping in U.S. flag ships).

The DISC provision adopted in the current bill is broadly similar to that which was incorporated in the Trade Act of 1970 which passed the House. However, in this bill, your committee has revised the DISC provision so as to apply generally on an incremental basis to export income in excess of a specified base. Specifically, the advantages of the DISC proposal are to be available only for export income attributable to sales in excess of 75 percent of the average export sales of the corporate group to which the DISC belongs for the years 1968 through 1970. This procedure has the advantage of concentrating the benefits of the DISC treatment on firms which increase their exports and thus make a greater contribution to resolving our balance of payments problems.

III. REVENUE EFFECTS

Table 1 shows the overall impact of your committee's bill on calendar year tax liability and fiscal year tax receipts. As indicated by this table, the bill is expected to reduce tax liability by a net $1.7 billion in calendar year 1971, $7.8 billion in 1972, and $6.0 billion in 1973. It is estimated that fiscal year receipts will be reduced by $5.0 billion in fiscal year 1972, $6.1 billion in 1973, and $6 billion in 1974.

As indicated in Table 1, the net reduction in tax liability (and receipts) results from a combination of increases in liability (and receipts) through elimination of the ¾-year convention from the Asset Depreciation Range (ADR) System offset by decreases through liberalization of the exemption and standard deduction provisions of the individual income tax, reinstatement of the investment credit, repeal of the automobile and small truck excise taxes, and providing tax deferral for domestic international sales corporations (DISC).

Table 2 breaks down the estimates in Table 1 on the basis of the impact of the various reductions on individuals in a nonbusiness capacity and their impact on business (incorporated and unincorporated). Thus, under your committee's bill the tax liability of individuals in a nonbusiness capacity is estimated to be decreased by $2 billion for calendar year 1971, by $5 billion for calendar year 1972, and by $2.7 billion for calendar year 1973. Corporate business and individual business combined are estimated to have their tax liability increased by $350 million for calendar year 1971, decreased by $2.8 billion for calendar year 1972, and decreased by $3.3 billion for calendar year 1973.

Also indicated in Table 2 are the net tax changes for individuals in a nonbusiness capacity and for corporate and unincorporated business combined. Individuals in a nonbusiness capacity are shown to pay $4.3 billion less in fiscal year 1972, $3.4 billion less in fiscal year 1973, and $2.6 billion less in fiscal year 1974. Corporate and unincorporated business combined are shown to pay $650 million less in fiscal year 1972, $2.7 billion less in fiscal year 1973, and $3.4 billion less in fiscal year 1974.

Table 3 shows, by adjusted gross income class, and for each of the calendar years 1971–1973, individual income tax liability and the change and percentage change in tax liability under the bill. The percentage reduction in 1971 amounts to 10.4 percent for tax returns with income up to $3,000 and decreases from that level to a very small percentage change for returns with income of $15,000 and over. In 1972, the reductions amount to 46.5 percent for returns with income up to $3,000 and decrease more gradually to a reduction of less than one percent for returns with income of $100,000 and over.

Table 4 breaks down the changes in individual income tax liability set forth in Table 3 into the changes attributable to each of the three sources of the changes. Thus, the $1.2 billion of tax reduction in 1971 is broken down in Table 4 into the contribution of the liberalized exemption and standard deduction provisions ($1.4 billion), the contribution of reinstatement of the investment credit ($300 million), and the offsetting tax increase contributed by elimination of the ¾-year convention from the ADR System ($420 million). Similarly, 1972's net tax reduction ($3.5 billion) is made up of a $3.1 billion reduction, a $720 million reduction, and a $340 million increase.

Table 5 indicates, by adjusted gross income class, the number of individual income tax returns which become nontaxable as a result of the exemption and standard deduction provisions of the bill. It shows 325 thousand returns become nontaxable for 1971 (out of a total of 63.4 million), 2.8 million returns become nontaxable for 1972 and 1.9 million returns become nontaxable for 1973.

Table 6 presents data, by adjusted gross income class, on the extent to which the individual income tax provisions of the bill induce a shifting of tax returns from itemizing deductions to use of the standard deduction. For 1971 the table indicates a shifting of 1.3 million returns from itemized deduction returns to standard deduction returns; for 1972, a shifting of 3.3 million returns to standard deduction returns; and for 1973, a shifting of 2.2 million returns to standard deduction returns.

Seven additional tables shown in the appendix of this report provide further information as to the impact by adjusted gross income class of the individual income tax personal exemption and standard deduction changes made by this bill. In addition, an eighth and a ninth table give the tax burdens under present law and under the provisions of this bill for 1971–1973 for single and married couples with differing numbers of dependents and with selected levels of adjusted gross income and under varying assumptions as to deductible nonbusiness expenses.

TABLE 1.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 ON CALENDAR YEAR TAX LIABILITY 1971–73 FISCAL YEAR TAX RECEIPTS 1972–74 [1]

[In millions of dollars]

Provision	Calendar year tax liability			Fiscal year tax receipts		
	1971	1972	1973	1972	1973	1974
Liberalizing exemption and standard deduction provisions of the individual income tax:						
Eliminating phaseout from 1971 minimum standard deduction and increasing exemption from $650 to $675	−1,370			−1,370		
Advancing 1973's 15 percent standard deduction and $750 exemption to 1972		−2,190		−940	−1,250	
Increasing the minimum standard deduction to $1,300 for 1972 and thereafter		−1,040	−1,090	−450	−1,060	−1,110
Correcting individual income tax withholding				+200	+600	
Reinstating investment credit	−1,500	−3,600	−3,900	−2,420	−3,590	−3,960
Eliminating ¾-year convention from the asset depreciation range (ADR) system	+2,100	+1,700	+1,500	+2,470	+1,660	+1,420
Repealing automobile excise tax	−800	−2,200	−1,900	−2,200	−2,000	−1,800
Repealing truck (under 10,000 G.V.W. lbs.) excise tax	−100	−360	−360	−280	−360	−360
Providing tax deferral for domestic international sales corporations (DISC)		−100	−200	Neg.	−100	−200
Total	−1,670	−7,790	−5,950	−4,990	−6,100	−6,010

[1] Estimates for all provisions in this table reflect growth except for the provisions relating to excise taxes.

TABLE 2.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971 BY TYPE OF TAXPAYER, CALENDAR YEAR TAX LIABILITY 1971–73, FISCAL YEAR TAX RECEIPTS 1972–74[1]

[In millions of dollars]

Provision	Calendar year tax liability			Fiscal year tax receipts		
	1971	1972	1973	1972	1973	1974
Liberalizing exemption and standard deduction provisions of the individual income tax:						
Eliminating phaseout from 1971 minimum standard deduction and increasing exemption from $650 to $675	−1, 370			−1, 370		
Advancing 1973's 15 percent standard deduction and $750 exemption to 1972		−2, 190		−940	−1, 250	
Increasing the minimum standard deduction to $1,300 for 1972 and thereafter		−1, 040	−1, 090	−450	−1, 060	−1, 110
Individual, nonbusiness	−1, 370	−3, 230	−1, 090	−2, 760	−2, 310	−1, 110
Correcting individual income tax withholding				+200	+600	
Reinstating investment credit:						
Individual, business	−300	−720	−780	−370	−730	−780
Corporate	−1, 200	−2, 880	−3, 120	−2, 050	−2, 860	−3, 180
Corporate and individual, business	−1, 500	−3, 600	−3, 900	−2, 420	−3, 590	−3, 960
Eliminating ¾ year convention from the asset depreciation range system:						
Individual, business	+420	+340	+300	+450	+340	+290
Corporate	+1, 680	+1, 360	+1, 200	+2, 020	+1, 320	+1, 130
Corporate and individual, business	+2, 100	+1, 700	+1, 500	+2, 470	+1, 660	+1, 420
Repealing automobile excise tax: [2]						
Individual, business	−120	−330	−280	−330	−300	−270
Individual, nonbusiness	−600	−1, 650	−1, 430	−1, 650	−1, 500	−1, 350
Individual, business and nonbusiness	−720	−1, 980	−1, 710	−1, 980	−1, 800	−1, 620
Corporate	−80	−220	−190	−220	−200	−180
Corporate and individual	−800	−2, 200	−1, 900	−2, 200	−2, 000	−1, 800
Repealing truck (under 10,000 G.V.W. pounds) excise tax: [2]						
Individual, business	−40	−160	−160	−120	−160	−160
Individual, nonbusiness	−50	−160	−160	−130	−160	−160
Individual, business and nonbusiness	−90	−320	−320	−250	−320	−320
Corporate	−10	−40	−40	−30	−40	−40
Corporate and individual	−100	−360	−360	−280	−360	−360
Providing tax deferral for domestic international sales corporations (DISC):						
Corporate		−100	−200	Neg.	−100	−200
Total:						
Individual, nonbusiness	−2, 020	−5, 040	−2, 680	−4, 340	−3, 370	−2, 620
Individual, business	−40	−870	−920	−370	−850	−920
Individual, business and nonbusiness	−2, 060	−5, 910	−3, 600	−4, 710	−4, 220	−3, 540
Corporate	+390	−1, 880	−2, 350	−280	−1, 880	−2, 470
Corporate and individual, business	+350	−2, 750	−3, 270	−650	−2, 730	−3, 390
Grand total, corporate and individual	−1, 670	−7, 790	−5, 950	−4, 990	−6, 100	−6, 010

[1] Estimates for all provisions in this table reflect growth except for the provisions relating to excise taxes.
[2] Assumes that the benefits of these taxes are passed on to the purchasers of the automobiles or trucks.

TABLE 3.—INDIVIDUAL INCOME TAX LIABILITY UNDER PRESENT LAW AND DECREASE (—) OR INCREASE (+) UNDER THE REVENUE ACT OF 1971, CALENDAR YEARS 1971–73—BY ADJUSTED GROSS INCOME CLASS

[Dollar amounts in millions]

	1971			1972			1973 and thereafter		
		Tax change under committee bill			Tax change under committee bill			Tax change under committee bill	
Adjusted gross income class (thousands)	Tax under present law	Amount	Percent	Tax under present law	Amount	Percent	Tax under present law	Amount	Percent
$0 to $3	$531	−$55	−10.4	$490	−$228	−46.5	$445	−$184	−41.3
$3 to $5	2,715	−221	−8.1	2,482	−506	−20.4	2,352	−382	−16.2
$5 to $7	4,905	−299	−6.1	4,550	−561	−12.3	4,364	−383	−8.8
$7 to $10	11,222	−207	−1.8	10,721	−658	−6.1	10,228	−178	−1.7
$10 to $15	20,754	−256	−1.2	19,891	−753	−3.8	19,202	−81	−.4
$15 to $20	14,630	−122	−.8	14,158	−306	−2.2	13,891	−50	−.4
$20 to $50	18,912	−88	−.5	18,608	−322	−1.7	18,377	−114	−.6
$50 to $100	7,323	−7	−.1	7,257	−80	−1.1	7,217	−52	−.7
$100 and over	7,696	+7	+.1	7,669	−49	−.6	7,658	−48	−.6
Total	88,687	−1,248	−1.4	85,826	−3,463	−4.0	83,735	−1,472	−1.8

Note: Details may not add to totals because of rounding.

TABLE 4.—ESTIMATED INCREASE (+) OR DECREASE (—) IN INDIVIDUAL INCOME TAX LIABILITY [1] UNDER THE REVENUE ACT OF 1971, CALENDAR YEARS 1971–73, BY ADJUSTED GROSS INCOME CLASS

[In millions of dollars]

Adjusted gross income class (thousands)	Liberalization of exemption and/or standard deduction provisions (1971 income levels)			Reinstatement of the investment credit [2] (current income levels)			Elimination of ¾ year convention from the Asset Depreciation Range (ADR) System [2] (current income levels)			Total		
	1971 [3]	1972 [4]	1973 and thereafter [5]	1971	1972	1973	1971	1972	1973	1971	1972	1973
$0 to $3	−56	−225	−180	−3	−6	−7	+4	+3	+3	−55	−228	−184
$3 to $5	−227	−487	−358	−16	−37	−40	+22	+18	+16	−221	−506	−382
$5 to $7	−310	−526	−339	−27	−66	−71	+38	+31	+27	−299	−561	−383
$7 to $10	−223	−608	−115	−40	−95	−103	+56	+45	+40	−207	−658	−178
$10 to $15	−276	−689		−50	−121	−131	+70	+57	+50	−256	−753	−81
$15 to $20	−135	−267		−31	−75	−81	+44	+36	+31	−122	−306	−50
$20 to $50	−116	−231		−72	−172	−186	+100	+81	+72	−88	−322	−114
$50 to $100	−20	−39		−32	−77	−84	+45	+36	+32	−7	−80	−52
$100 and over	−5	−11		−29	−71	−77	+41	+33	+29	+7	−49	−48
Total	−1,368	−3,083	−992	−300	−720	−780	+420	+340	+300	−1,248	−3,463	−1,472

[1] Exclusive of the impact of repeal of the excise tax on automobiles and small trucks (under 7,500 G.V.W. pounds) on the individual income tax liability of sole proprietors and partners.

[2] Change in tax liability of sole proprietors and partners.

[3] Elimination of the phaseout from the 1971 minimum standard deduction and increasing the exemption from $650 to $675.

[4] Advancement of 1973's 15 percent standard deduction and $750 exemption to 1972 and increase in the minimum standard deduction from $1,000 to $1,300.

[5] Increase in the minimum standard deduction from $1,000 to $1,300.

TABLE 5.—TAXABLE INDIVIDUAL INCOME TAX RETURNS UNDER PRESENT LAW AND NUMBER MADE NONTAXABLE AND NUMBER REMAINING TAXABLE BUT BENEFITING UNDER THE EXEMPTION AND STANDARD DEDUCTION PROVISIONS OF THE REVENUE ACT OF 1971, CALENDAR YEARS 1971–73, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

[In thousands]

Adjusted gross income class (thousands)	1971			1972			1973		
	Returns taxable under present law	Returns made nontaxable by the provisions	Returns remaining taxable but benefiting from the provisions	Returns taxable under present law	Returns made nontaxable by the provisions	Returns remaining taxable but benefiting from the provisions	Returns taxable under present law	Returns made nontaxable by the provisions	Returns remaining taxable but benefiting from the provisions
$0 to $3	5,555	170	5,385	5,531	1,774	3,757	5,257	1,500	3,674
$3 to $5	9,460	95	9,365	9,273	691	8,582	8,947	366	7,404
$5 to $7	9,154	58	9,096	9,069	269	8,800	8,868	68	6,810
$7 to $10	13,316	2	13,314	13,316	44	13,272	13,275		5,132
$10 to $15	15,084		15,084	15,084		15,084	15,084		
$15 to $20	6,334		6,334	6,334		6,334	6,334		
$20 to $50	4,014		4,014	4,014		4,014	4,014		
$50 to $100	398		398	398		398	398		
$100 and over	99		99	99		99	99		
Total	63,415	325	63,088	63,117	2,777	60,340	62,277	1,933	23,021

Note: Details may not add to totals because of rounding.

TABLE 6.—TAXABLE INDIVIDUAL INCOME TAX RETURNS WITH STANDARD DEDUCTION AND WITH ITEMIZED DEDUCTIONS UNDER PRESENT LAW AND NUMBER OF RETURNS SWITCHING TO THE STANDARD DEDUCTION UNDER THE STANDARD DEDUCTION PROVISIONS OF THE REVENUE ACT OF 1971—CALENDAR YEARS 1971–73, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

[In thousands]

Adjusted gross income class (thousands)	1971				1972				1973			
	Under present law			Under committee bill	Under present law			Under committee bill	Under present law			Under committee bill
	Total	With itemized deductions	With standard deduction	Returns switching from itemizing deductions to the standard deduction	Total	With itemized deductions	With standard deduction	Returns switching from itemizing deductions to the standard deduction	Total	With itemized deductions	With standard deduction	Returns switching from itemizing deductions to the standard deduction
$0 to $3	5,555	168	5,387	20	5,531	168	5,362	141	5,257	169	5,089	141
$3 to $5	9,460	1,821	7,639	230	9,273	1,590	7,682	577	8,947	1,487	7,460	577
$5 to $7	9,154	3,303	5,851	701	9,069	2,696	6,373	1,000	8,868	2,590	6,278	1,000
$7 to $10	13,316	6,593	6,724	317	13,316	5,978	7,338	916	13,275	5,503	7,772	446
$10 to $15	15,084	9,739	5,345		15,084	8,165	6,919	657	15,084	7,508	7,576	
$15 to $20	6,334	5,150	1,184		6,334	4,223	2,111		6,334	4,223	2,111	
$20 to $50	4,014	3,684	330		4,014	3,395	619		4,014	3,396	619	
$50 to $100	398	391	7		398	385	14		398	384	14	
$100 and over	99	98	1		99	97	1		99	98	1	
Total	63,415	30,948	32,467	1,268	63,117	26,697	36,419	3,291	62,277	25,357	36,920	2,164

Note: Details may not add to totals because of rounding.

IV. GENERAL EXPLANATION

A. Job Development Investment Credit; Depreciation Revision

1. Restoration of investment credit (sec. 101 of the bill and secs. 49 and 50 of the code)

Prior to 1969, there was a 7-percent investment tax credit (3 percent for public utility property). The Tax Reform Act of 1969 repealed this investment credit for property acquired after April 18, 1969, and for property the construction, reconstruction, or erection of which began after April 18, 1969. In general terms, the investment credit under prior law was available with respect to: (1) tangible personal property; (2) other tangible property (not including buildings and structural components) which was an integral part of manufacturing, production, etc., or which constituted a research or storage facility; and (3) elevators and escalators. New property fully qualified for the credit, but in the case of used property, only an amount up to $50,000 could be taken into account in any one year. In addition, the property had to be depreciable property with a useful life of at least 4 years. Property with a useful life of from 4 to 6 years qualified for the credit to the extent of one-third of its cost. Property with a useful life of 6 to 8 years qualified with respect to two-thirds of its cost, and property with an estimated useful life of 8 years or more qualified for the full amount.

The amount of the investment credit taken in any year could not exceed the first $25,000 of tax liability (as otherwise computed) plus 50 percent of the tax liability in excess of $25,000. Investment credits which because of this limitation could not be used in the current year could be carried back to the 3 prior years and used in those years to the extent permissible within the limitations applicable in those years, and then, to the extent of any amount still remaining, carried forward and used to the extent permissible under the applicable limitations in the succeeding 7 taxable years.

A special rule provided that carryovers to 1969 and subsequent years could be used in any such year only to the extent of 20 percent of the carryovers. In these cases instead of a 7-year carryover, a 10-year carryover was provided to the extent the credit was limited by the 20-percent factor.

As indicated in the discussion of the reasons for the bill, your committee concluded that the 7-percent investment credit should be restored as a means of providing stimulus to the lagging domestic economy by reducing the cost of capital to U.S. manufacturers. This will also serve to place them in a more competitive position with foreign manufacturers and in that manner help improve our present serious balance-of-payments situation.

The bill provides for a 7-percent investment credit which is substantially similar to the investment credit allowed under prior law. The three principal differences from the credit previously allowed are (1) the useful life brackets used in determining the amount of investment in property which is eligible for the credit are to be shortened by 1 year, (2) the credit is not to be allowed for foreign-produced machinery and equipment so long as the tempo-

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rary additional duty remains in effect, and (3) public utility property is to be eligible for a 4-percent rather than a 3-percent credit.

The credit is to be available with respect to property acquired by the taxpayer after August 15, 1971, or in the case of property which is constructed, reconstructed, or erected by the taxpayer, where the construction is completed after August 15, 1971 (regardless of the time when construction, etc. began). In this latter case, however, the credit is to be available only with respect to that part of the basis of the property properly attributable to construction, etc., after August 15, 1971. The credit also is to be available with respect to property, the construction of which by the taxpayer is begun after March 31, 1971, and property which is acquired after March 31, 1971, and before August 16, 1971, if the taxpayer can clearly establish that the acquisition was made pursuant to an order placed after March 31, 1971. These categories of property which qualify for the credit provided by the bill are referred to in the subsequent discussions as qualifying property (in the bill they are referred to as sec. 50 property). Any property which is pre-termination property and thus eligible for the credit under prior law will continue to be eligible for the credit. (This pre-termination property is included as "section 50 property" in the bill and is included in the term "qualifying property" in this report.)

2. Determination of qualified investment (sec. 102 of the bill and secs. 46 and 47 of the code)

In order to more realistically reflect the useful lives of property in determining the amount of allowable investment credit, the bill shortens by one year the useful life brackets used in determining the portion of investment in property which qualifies for the credit. Under the bill, property with a useful life of 3 to 5 years is to qualify for the credit to the extent of one-third of its cost. Property with a useful life of 5 to 7 years will qualify for the credit to the extent of two-thirds of its cost, and property with a useful life of 7 years or more is to qualify for the full amount. These replace brackets of 4 to 6 years for a one-third credit, 6 to 8 years for a two-thirds credit, and 8 years and over for a full credit.

In addition, a conforming change is made in the rule of prior law under which there is no recapture of the credit in the case of certain aircraft leased for use outside the United States where this foreign use does not exceed 4 years (i.e., one-half of the 8-year life required for the full amount of the credit). In view of the reduction of the 8-year life requirement to 7 years, the permissible amount of foreign use in the case of these aircraft is reduced to 3½ years. This amendment with respect to leased aircraft used abroad is to apply with respect to leases entered into after April 18, 1969.

As was previously the rule, it is provided that a taxpayer must use the same useful life with respect to an asset in determining the amount of the allowable investment credit as the taxpayer uses in computing depreciation or amortization on the asset.

The changes made by the bill with respect to the useful life brackets are to apply with respect to qualifying property. In addition, the changes are to apply for purposes of the recapture rules in the case of any property disposed of after August 15, 1971 (and any property which otherwise ceases to qualify with respect to the taxpayer). Thus, in the case of property disposed of after this date with respect to which the full amount of the credit was originally allowed (i.e., because it had a useful life of 8 years or more), there is to be no recapture if the disposition occurs after 7 years of use by the taxpayer.

3. Limitation of credit to domestic products (sec. 103 of the bill and sec. 48(a) of the code)

In view of our balance of payment difficulties, your committee believes that the credit should be available only with respect to domestically produced property during the period the temporary 10 percent additional duty is in effect. As a result, the bill provides that the credit is not to apply with respect to any foreign produced property which the taxpayer acquires prior to the termination of the additional duty proclaimed by the President on August 15, 1971 (or any property which is acquired at any time as the result of an order placed before that termination date). In the case of property constructed, reconstructed, or erected by the taxpayer, the credit is not to be available for any portion of the cost of the property if the construction, etc., is begun before the termination date of the additional duty. The limitation of the credit to domestically-produced goods during this period, however, is not to apply to any pre-termination property which is eligible for the credit under prior law.

For purposes of this limitation, foreign produced property includes all property which is completed outside the United States regardless of the U.S. content of the property. In other words, any finished property imported into the United States is to be treated as foreign produced property even though substantially all of its value is represented by components which were manufactured or produced in the United States. An article is to be deemed completed outside the United States if it enters the country in a form which is operational for the purposes for which it is intended; minor activities such as packaging or labeling in the United States are not to remove the property from classification as property completed outside the United States.

Foreign produced property also includes any property completed in the United States, if less than 50 percent of the basis of the property is attributable to value added inside the United States. For this purpose, shipping and insurance costs incurred in transporting property to this country as well as any duty payable upon entry of the property into the United States are to be treated as foreign value. On the other hand, any selling profit as well as any profit attributable to any other U.S. activities in the case of a final product completed in the United States is to be treated as value added in the United States.

The buyer, of course, has the normal obligation of establishing for tax purposes that the property qualifies for the credit. It is expected that when there is doubt in the minds of the buyers whether properties qualify for the investment credit because of this provision, they will seek warranties from sellers. Thus, in such cases if the property should prove not to be eligible for the credit because of its foreign content, the seller would recompense the buyer for any loss of the investment credit. This would operate as a result of general contract law, however, rather than as a result of tax law.

To prevent the application of this limitation on the credit in situations where it is appropriate to make the credit available with respect to a type or class of foreign produced articles because of other overriding considerations, the bill provides the President with authority to waive (by Executive order) the limitation for an article or class of articles, if he determines that it is not in the public interest for the property to be denied the credit. A determination by the President under this authority is to apply only to property ordered on or after (or to property on which construction is begun on or after) the issuance of the Executive order or such later date as is specified in the order. The determination may be made applicable for any period after its issuance by the President. The types of situations in which the President may find that it is in the public interest to waive the limitation include those: (1) where the U.S. market for a particular type of item tends toward a monopolistic one (i.e., is dominated by one or two domestic producers); (2) where there are practically no U.S. manufacturers of the type of products involved and substantially all items of these types are imported; and (3) where the foreign producer of an item can show that it is seeking to develop a market in the United States prior to transferring the manufacturing operations for the item to the United States.

4. Definition of section 38 property (sec. 104 of the bill and secs. 48(a) and 169 of the code)

Livestock.—In the past the investment credit generally was available for any depreciable tangible personal property subject to the depreciation recapture rules. Your committee believes that this should continue to be the case in the future. Prior to 1969, however, the depreciation recapture rules did not apply to livestock. In 1969, livestock was placed in the same position as other types of business property in that it was made subject to the depreciation recapture rules. As a result, your committee concluded that consistent treatment under the credit required that livestock be made eligible for the credit.

In determining whether livestock acquired by a taxpayer is new or used property for purposes of the credit, your committee intends that livestock be treated in a manner consistent with that provided in the Treasury regulations for other types of property. Property is considered new property for purposes of the credit if its original use commences with the taxpayer. The regulations provide that the term "original use" means the first use to which the property is placed, whether or not the use corresponds to the use of the property by the taxpayer. However, where the property qualifies as a breeding or dairy animal, it will normally be regarded as a new article at the time it is first used for these purposes, that is, at the time its suitability is established by the bearing of a calf or the giving of milk, assuming it has not been used for other purposes prior to that time. On the other hand, if a cow has been used for dairy purposes and later is used for breeding purposes, it will not be "new" property when first used for breeding purposes.

Comsat.—Under prior law, property was not eligible for the credit if it was used by an international organization or any agency or instrumentality of such an organization, or if it was used predominantly outside the United States. The application of these rules was unclear in the case of contributions by the Communications Satellite Corporation (Comsat) to the program of the International Telecommunications Satellite Consortium (Intelsat) in orbiting space satellites. Comsat is the United States participant in the Intelsat joint venture formed under 1964 international arrangements to establish a global communications satellite system. Under the 1964 arrangements, the participants in Intelsat own the space segment (primarily satellites) of the satellite system in the form of undivided shares based on their respective contributions to the cost of the space segment. Under recently negotiated arrangements signed by the United States and Comsat on August 20, 1971, Intelsat will itself own the space segment.

Your committee believes that exclusion of these communications satellites from the credit would tend to frustrate Congress' purpose in the Communications Satellite Act of 1962 to establish," in cooperation with other countries, as expeditiously as practicable a commercial communications satellite system" (47 U.S.C. 701(a)). As a result, the bill provides that the use of property by Intelsat is not to disqualify the property from the credit insofar as Comsat is concerned. In addition, it is provided that communications satellites (as defined in section 103(3) of the Communications Satellite Act of 1962) are not to be disqualified from the credit on the basis that they are used outside the United States.

Amortized property.—Under prior law, various rules were provided regarding the availability of the credit for property subject to special 5-year amortization. For a limited period of time railroad rolling stock, expenditures for rehabilitating low-income housing, and certain coal mine safety equipment were eligible for special 5-year amortization provision as well as for the credit. On the other hand, the credit was denied to expenditures for pollution control facilities subject to special 5-year amortization.

These special amortization provisions were enacted as part of the Tax Reform Act of 1969 which also repealed the investment tax credit. Moreover, in large measure these amortization provisions were intended as a substitute for the investment credit then being repealed. In view of the reinstatement of the credit, your committee has concluded that it is not appropriate to provide both the credit and special 5-year amortization with respect to the same property.

As a result the bill provides that if the taxpayer elects the special 5-year amortization provided for pollution control facilities, railroad rolling stock, coal mine safety equipment, expenditures for the rehabilitation of low-income housing, job training facilities, or day care facilities (the last two categories are new amortization provisions added by this bill), the property subject to the amortization election is not to be eligible for the credit. (If the amortization election is made subsequent to the allowance of the credit, the credit is to be retroactively denied for the year in which it was previously allowed.) Since in the case of pollution control facilities only the proportion of the cost of the facility attributable to the first 15 years of its useful life is eligible for special 5-year amortization, the bill provides that the credit is to be denied only for the portion of the cost of a facility subject to rapid amortization. Therefore, a taxpayer acquiring a pollution control facility may be eligible for the credit with respect to the cost attributable to the useful life in excess of 15 years even though he elects rapid amortization with respect to the property.

Effective dates.—The changes made by the bill in the treatment of livestock and property subject to special amortization are to apply to qualifying property other than pre-termination property. The changes made regarding the treatment of Comsat are to apply to years ending after 1961. As a result, Comsat will be eligible for the 3-percent credit of prior law and the 4-percent credit provided by this bill (see *6. Regulated Companies*, below).

5. Used Property (sec. 105 of the bill and sec. 48(c) of the code)

Under prior law the cost of any used property which could be taken into account for purposes of the credit was limited to $50,000 a year. In the case of a husband and wife filing separate returns, the amount of used property which could be taken into account was $25,000, instead of $50,000, unless one of the two had not purchased any used investment credit property, in which case the other spouse could claim the entire amount up to $50,000. Prior law also contained rules for allocating the $50,000 limitation among component members of a controlled group of corporations and a provision that the $50,000 limit applied at both the partnership and partner levels.

Your committee has, with two modifications, retained the rules of prior law insofar as the allowability of the credit for used property is concerned. First, in view of the price level increases which have occurred, the dollar limitation on the amount of used property eligible for the credit has been increased to $65,000. Second, since the purpose of allowing the credit with respect to used property is to make the credit available to small business which does not have the financial ability to acquire new property, your committee has provided that the limitation on the used property allowance is to be reduced to the extent the taxpayer acquires new property. Thus, the bill provides that the $65,000 limitation is to be reduced by the amount of qualified investment attributable to new investment credit property which is placed in service by the taxpayer during the year. This means that if a taxpayer places in service new investment credit property representing a qualified investment of $40,000, the taxpayer's used property dollar limitation will be reduced from $65,000 to $25,000. Accordingly, if during the same year the taxpayer acquires used investment credit property with a cost of $30,000, only $25,000 of that amount will be eligible for the credit.

In the case of a husband and wife filing separate returns, the amount of used property which may be taken into account by each spouse is $32,500 (reduced by the amount of investment attributable to new investment credit property placed in service by that spouse). If only one of the spouses has purchased used investment credit property, that spouse may claim the entire amount up to $65,000 (reduced by the aggregate amount of new property placed in service by both spouses).

In the case of a controlled group of corporations, there is to be one $65,000 used property allowance for the group, adjusted by the qualified investment in new property of all members of the controlled group and then apportioned among the members of the group in accordance with their purchases of used property.

In the case of partnerships, the dollar limitation applies at the parnership level and also with respect to each partner. (This is also true with respect to subchapter S corporations and their shareholders.) For example, assume that A and B are equal partners and that the partnership places in service new investment credit property representing a qualified investment of $40,000. Further assume that the partnership purchases $50,000 of used investment credit property. Since the partnership invested $40,000 in new property, only $25,000 of the used property investment at the partnership level will be allowable pro rata to A and B. In addition, the partnership's investments in new property will be attributed pro rata to A and B for purposes of determining the limitation on their individual used property allowances (and also for purposes of determining their credit for the new property). Thus, for this purpose A and B will each be considered to have purchased $20,000 of new property. Assume further that A and B as individuals each purchased qualified new property of $5,000. Accordingly, the limitation on their used property allowance in their individual capacity is reduced to $45,000 by the attributed new investment, and is further reduced by $5,000 representing the new property purchased by each of them as individuals, reducing their limits for used property to $40,000 each. Each partner's share of partnership investment in used property ($12,500), along with investments in used property made in their individual capacity, may be applied against their respective $40,000 limits.

6. Regulated Companies (sec. 106 of the bill and sec. 46(e) of the code)

Prior law.—In general, under prior law, a 3-percent investment credit was provided for public utility property (in contrast to the 7-percent credit given for other property). Public utility property was defined for this purpose as property used predominantly in the trade or business of furnishing or selling (1) electrical energy, water, or sewage disposal services, (2) gas through a local distribution system, (3) telephone service, or (4) domestic telegraph service (if the rates for these services or items were established or approved by certain types of governmental regulatory bodies).

As part of the Revenue Act of 1964 (sec. 203(e) of that Act), Congress provided that, in the case of the investment credit on public utility property (the 3-percent property), no Federal regulatory agency could "flow through" the credit to income more rapidly than ratably over the useful life of the property. In the case of any other regulated company's property (the 7-percent property—chiefly, the interstate gas pipelines), no Federal regulatory agency could flow-through to income any part of the credit. In each of these categories, flowthrough was nevertheless permitted if the company consented; where the company was earning the maximum allowed by law or regulations, this resulted in flowing through the tax reduction to the company's current customers in the form of lower utility rates.

Reasons for provisions.—In restoring the investment credit, your committee concluded that it was appropriate to increase somewhat the credit previously available for regulated companies. As indicated above, the prior law's rate for most public utility property was 3 percent. Your committee's bill raises the rate for public utility property to 4 percent. In part, this is provided because of the increasing problem many utilities are encountering in raising the capital required for modernization and expansion. Additionally, the regulated companies are encountering increased competition from other regulated companies and, in the case of many of their products, from unregulated companies as well. In view of these factors, your committee concluded that it was apropriate to lessen the difference between the credit allowable for public utilities and for taxpayers generally.

Your committee also is concerned that some regulated companies which previously received the 3-percent credit (and under this bill are to receive 4 percent) are in substantial competition with companies eligible under prior law for the full 7-percent credit. As a result, changes have been made in the categories of property to which the 4-percent credit—as distinct from the 7-percent credit—is to be available. These changes have been made in order to equalize the treatment of regulated companies in substantial competition with each other.

In restoring the investment credit for public utility property of regulated companies, the committee has given careful consideration to the impact of this credit on ratemaking decisions. Although there are many different ways of treating the credit for rate making purposes, your committee, in general, believes that it is appropriate to divide the benefits of the credit between the customers of the regulated industries and the investors in the regulated industries.

To permit all of the benefits of the credit to be flowed through to the consumer currently could have an impact on revenues which is approximately twice that applicable in other cases. Moreover, the basic purpose of the investment credit is not an allocation of resources which will stimulate consumption of any particular type of product or service. For these reasons, as a general rule, your committee's bill does not make the credit available where all of the benefit from it would be flowed through currently to the consumers. There are a limited number of cases, however, where a regulated company particularly needs to maintain a low rate for consumers, and has under prior law flowed the benefits of fast depreciation through currently to the consumers. In these cases alone, your committee makes the credit available even though the utility elects to flow through the credit currently to the consumer. In all other cases, the credit is made available only where there is assurance that some of the benefit at least, will go to the investors. Your committee believes that this represents the best balancing of the considerations of both investors and customers of the regulated companies, and the extent to which revenue losses may be permitted at this time.

Investment credit rate.—As indicated above, the bill increases the credit for public utility property to 4 percent (i.e., the amount of the qualified investment applicable to this property is raised from 3/7ths to 4/7ths of the cost of the property). The bill also provides that for the future property used predominantly in furnishing or selling of all telegraph services or other communication services [1] is to receive the 4-percent credit.[2] Thus, property used in overseas telegraph operations

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[1] This is in addition to the categories indicated above; namely, (1) electrical energy, water, and sewage disposal services, (2) gas through a local distribution system, (3) telephone service, and (4) domestic telegraph service.

[2] Since this change applies only to property eligible for the new investment credit under the bill, this change in the categories of partial-credit property will not, by itself, give rise to an increase in tax under section 47(a)(2).

and property used in miscellaneous types of regulated communications services, such as data transmission operations, are to receive the 4-percent rather than the 7-percent credit.

The communications operations of Comsat are includable within the prior law's term, "telephone services."

Treatment of credit in ratemaking.—With regard to the treatment of the credit for ratemaking purposes, the bill provides three basic elective options:

(1) The first option provides that the investment credit is not to be available to a company with respect to any of its public utility property if any part of the credit to which it would otherwise be entitled is flowed through to income; however, in this case the tax benefits derived from the credit may (if the regulatory commission so requires) be used to reduce the rate base, provided that this reduction is restored over the useful life of the property.

(2) The second option provides that the investment credit is not to be available to a company with respect to any of its public utility property if the credit to which it would otherwise be entitled is flowed through to income faster than ratably over the useful life of the property; however, in this case there must not be any adjustment to reduce the rate base if the credit is to be available.

(3) Under the third of the elective options, the above restrictions would not apply at all.

All regulated companies are to be allowed to choose between option (1) and option (2) but the choice must be made within 90 days after the date of the enactment of this bill. If no election is made in that time period, option (1) applies.

Option (3) is to be available (as an alternative to option (1) or option (2)) only to a regulated company which is a "flow-through" company under the accelerated depreciation rules enacted as part of the Tax Reform Act of 1969. Election of this option also must be made within 90 days after the enactment of this bill.

Congress considered a somewhat similar problem in 1969 with respect to the tax benefits of accelerated depreciation. There, too, it was determined to provide a general rule under which the tax benefits could be shared between investors and customers. An exception was provided in those situations where a company was already flowing through the tax benefits of accelerated depreciation, in order to recognize the special competitive conditions under which such a company was operating and in order to avoid precipitating an increase in utility costs to such a company's customers. Property of these regulated companies (described in sec. 167(l) (2) (C)) is eligible for option (3) if an election is made. Although the depreciation problem is in many respects similar to the matter considered in this bill, it is not identical. Nevertheless, the result of this bill—generally involving sharing of benefits—is essentially similar to the result of the 1969 depreciation legislation.

The options described above, regarding flow through and rate base adjustments, are to apply to property which is eligible for the 4-percent credit and also to property eligible for the 7-percent credit which is used for local steam distribution or for gas or steam transportation by pipeline.

In determining the period of time over which the investment credit may be ratably flowed through or over which any rate base adjustment must be amortized, reference is to be made to the period of time on the basis of which depreciation expense is computed on the company's regulated books of account, and not to the useful life used for depreciation under the Internal Revenue Code. A ratable method of flowing through or amortizing is to include a method in which equal amounts are allocated to equal time periods, equal units of production or machine hours. Composite lives and other averaging methods may be used where appropriate and in accord with regulations.

In determining whether or to what extent a credit reduces cost of service, i.e., has been flowed through to income, reference is to be made to any accounting treatment that can affect cost of service. One usual method of flowing through the investment credit is to reduce the amount of Federal income tax taken into account. Another method of flowing through the investment credit is to reduce, by the amount of the credit, the depreciable basis of the property on the regulated books of account.

In determining whether or to what extent a credit has been used to reduce the rate base, reference is to be made to any accounting treatment that can affect the company's permitted profit on investment by treating the credit in any way other than as though it had been contributed by the company's common shareholders. For example, any lesser "cost of capital" assigned to the credit would be treated as, in effect, a rate base adjustment.

The bill provides the Secretary or his delegate with authority to deal with those situations under which the literal application of the provisions of these rules does not carry out the purposes of this subsection. This regulatory authority is identical, within its sphere, to the authority granted under the Tax Reform Act of 1969 in the case of the treatment of accelerated depreciation by regulated industries.

As indicated above, Congress instructed Federal regulatory agencies in 1964 as to the permitted limits of flow through of the investment credit. This rule, however, did not apply to State and local regulatory agencies. The wide variety of practices followed among the State and local regulatory agencies, makes it imperative that some time is allowed for those agencies to conform their practices to one of the permitted options under this bill. In recognition of this matter, your committee has determined that these provisions are not to apply until April 1, 1972.

If a regulatory agency nevertheless flows through a company's investment credit at a rate faster than permitted under the applicable option, or insists upon a greater rate base adjustment than is permitted under the applicable option, then that company will not be allowed to take any investment credit for that period and for any taxable periods that are open at the time the limitations of the applicable options are exceeded by the agency.

Effective date.—These provisions of the bill regarding regulated companies are to apply to property, including pre-termination property, which qualifies for the new investment credit.

7. Investment credit carryovers and carrybacks (sec. 107 of the bill and sec. 46 of the code)

Under existing law, the amount of credit which a taxpayer may claim in a year generally is limited to 50 percent of his tax liability (the credit may be claimed against 100 percent of tax liability up to $25,000). A 3-year carryback and a 7-year carryforward is provided for credits which may not be used in the current year because of this 50-percent limitation. The 50-percent limitation for a year is applied first against the credits arising in that year and then, to the extent of any remaining limitation, to carryovers of unused credits to that year. When the investment credit was repealed in 1969, an additional limitation was imposed on the use of carryovers of unused credits to reflect the fact that new credits would not generally arise in future years and, thus, in the absence of a limitation, there could be a substantially greater use of unused credit carryovers which would have significantly delayed the impact of the repeal. Generally, it was provided that the amount of unused credit carryovers which could be used in 1969 and later years could not exceed 20 percent of the aggregate amount of carryovers to 1969. In addition, the carryover period was extended to 10 years for credits which could not be used in a year solely because of this limitation.

In view of the fact that the allowance of a credit for newly acquired property will place a limit on the use of carryovers similar to that provided in prior law, your committee believes that the special 20-percent limitation should be removed in the case of carryovers to future years. As a result the bill provides that this special limitation is not to be applicable to carryovers to taxable years ending after December 31, 1971.

In addition, it was brought to your committee's attention that many taxpayers have substantial amounts of investment credit carryovers which arose in the past that the taxpayers will not be able to use either because the carryover period will expire or because credits arising in the future will completely absorb the 50-percent limitation which will prevent the use of carryovers. Your committee is concerned about this situation since the desire of taxpayers to use these credit carryovers as quickly as possible (to avoid losing them) could significantly dampen the stimulative effect of restoring the investment credit. In view of this, your committee's bill deals with this problem in two respects. First, the bill provides for a reversal of the application of currently generated credits and carryovers against the 50-percent limitation with respect to carryovers from 1970 and earlier years. It is provided that the 50-percent limitation for 1971 or a later year is to be first absorbed by carryovers from pre-1971 years to that year and then, to the extent of any remaining limitation, by credits arising in that year. Second, the bill provides that carryovers of unused credits from 1970 and earlier years to the extent they have not previously expired are to be allowed a 10-year, rather than a 7-year, carryforward.

The rules discussed above do not apply to carryovers of unused credits from 1971 and later years. Accordingly, in a year after 1971, the 50-percent limitation for the year is to be first absorbed by carryovers from pre-1971 years, then by the credits generated in that year, and finally by carryovers to that year from 1971 and later years.

The removal of the 20-percent limitation is to apply with respect to taxable years ending after December 31, 1971. The changes in the order in which credits are to be used is to apply with respect to taxable years beginning after December 31, 1970. The 10-year carryover for unused credits arising before 1971 is to apply to years beginning after December 31, 1970.

8. Exceptions to recapture rules (sec. 108 of the bill and secs. 46(c) and 47(a) of the code)

Prior law provided for the recapture of the investment credit to the extent property was disposed of before the end of the period (that is, 4–6, 6–8, or 8 or more years which the bill changes to 3–5, 5–7, or 7 or more years) which was used in determining the amount of the credit originally allowed. An exception to this recapture rule provided that where the property was stolen or damaged or destroyed by casualty and replaced by property eligible for the investment credit there was no recapture of the credit with respect to the casualty property but, instead, the credit for the replacement property was reduced by a comparable amount. In addition, when the investment credit was repealed in 1969, a transitional rule was added providing that where because of the termination of the investment credit, the taxpayer could not avoid the effects of recapture by acquiring new property (since the investment credit at that time was no longer available), the recapture rules were not to apply.

Your committee concluded that, since the investment credit is being restored—with the result that replacement property is eligible for the credit—there is no reason to continue any exceptions to the recapture rules. As a result, the bill eliminates the exceptions to the recapture rules for casualties, thefts, and other dispositions. This has the effect of treating casualties and thefts as dispositions and, thus, subjecting all dispositions to the recapture rules.

The repeal of the exception to the recapture rules for property destroyed by casualty or theft applies to casualties occurring after August 15, 1971. In the case of the provision which makes the recapture rules inapplicable where there is a replacement of the property disposed of, the repeal of this provision applies if the replacement property is eligible for the credit under the bill. Thus, where the replacement property is eligible for the restored credit, the property disposed of (which it replaces) is to be subject to the recapture rules.

9. Availability of credit to certain lessors (sec. 109 of the bill and sec. 46(d) of the code)

Under prior law, a lessor of investment credit property was entitled to the credit with respect to the property. It also was provided that the lessor could elect, with respect to new property, to pass the credit through to the lessee rather than claim it himself.

Your committee believes that making the credit available to the lessor is desirable, as a general rule, as a way of making the investment credit useful where the taxpayer has little if any tax liability. This is because the benefits of the credit normally are passed on, in large part, to the lessee in the form of reduced prices. Nevertheless, it is concerned about the extent to which individuals (singly or as a group in a joint venture) are able to utilize the tax benefits of leasing transactions (the credit, and the depreciation and interest deductions) as a means to shelter from tax a substantial part of their other income. As a result of the Tax Reform Act, these transactions are less attractive than before because the interest and accelerated depreciation deductions are generally subject to the minimum tax and reduce an individual taxpayer's right to use the 50 percent maximum rate on earned income. Your committee is concerned, however, that the restoration of the credit could once again make leasing arrangements motivated largely by tax reasons quite attractive. To prevent such a result your committee believes that it is appropriate to limit the extent to which the credit is available to individual lessors (and other noncorporate lessors).

The bill provides that the credit is to be available to an individual (or other noncorporate) lessor in only two situations. First, if the property which is the subject matter of the lease has been manufactured or produced by the lessor, the lessor is not to be denied the credit. The terms "manufacture" and "production" in this case include the construction or reconstruction of property. Thus, if two individuals are in the business of manufacturing a product and then lease instead of sell the product, they are not to be denied the credit with respect to the product assuming it otherwise qualifies as investment credit property. In these situations, the lease arrangement is an integral part of the taxpayer's business and is not likely to have been entered into for the purpose of reducing tax liabilities.

Second, the bill provides, in general, for the allowance of the credit in the case of short-term leases since in these cases the leasing activity constitutes a business activity of the taxpayer, rather than a mere investment, i.e., a financing arrangement. The bill provides that two conditions must be satisfied for the credit to be available to a noncorporate lessor under this alternative. First, the term of the lease (taking into account options to renew or extend) must be less than 50 percent of the useful life of the property subject to the lease. The useful life of the property for this purpose is the life used in determining the amount of allowable credit and for depreciation purposes. Second, for the first 12 months after the transfer of the property to the lessee, the sum of the deductions allowable to the lessor with respect to the leased property solely by reason of section 162 (other than rental payments and reimbursed expenses with respect to the property) must exceed 15 percent of the rental income produced by the property during the 12-month period. If these conditions exist, your committee believes that the lease is quite likely to represent a normal business transaction of the lessor rather than a passive investment entered into for the purpose of sheltering other income.

The limitations provided by the bill also are to apply to a lease of property by a partnership. Thus, if a lease by a partnership satisfies either alternative test, the credit will be allowed to the partners.

A lease by a subchapter S corporation is, for purposes of this provision, to be treated in the same manner as a lease by a partnership. Thus, if a lease by a subchapter S corporation does not qualify under one of the two alternatives pursuant to which an individual lessor may be allowed the credit, the credit is not to be allowed to the subchapter S corporation or its shareholders.

Even though an individual lessor under this provision of the bill is denied the credit, he may still elect to pass it through to the lessee. In this manner the credit is not denied to the acquisition itself, but simply to the lessor.

The amendments made by this section are to apply to leases entered into after September 22, 1971.

10. Basis Adjustment

Your committee has not provided a basis adjustment mechanism, at this time, such as that employed in the past, in view of your committee's concern that the investment credit provided by the bill have as great a stimulative effect on the economy as possible. Generally, a basis adjustment mechanism provides for a reduction in the depreciation base of property for which an investment credit is allowed by the amount of the credit, and it would be necessary to provide a larger credit subject to a basis adjustment to obtain the same overall stimulative effect. Your committee, however, has directed the staffs of the Treasury Department and the Joint Committee on Internal Revenue Taxation to study and develop a basis adjustment mechanism for consideration by the committee within the next two years. It is expected that this study will also review the advisability of retaining the useful life limitations and the limitations based on the taxpayer's tax liability in the present investment credit provisions.

11. Reasonable allowance for depreciation; repair allowance (sec. 110 of the bill and secs. 167 and 263 of the code)

Prior actions.—Before 1962, business firms depreciated their property in terms of useful lives that were established for several thousand different classifications of assets (so-called Bulletin "F" lives). The guideline lives for depreciable assets that were put into effect in 1962 consolidated assets into about 75 broad asset classes and also shortened the prescribed lives by up to 30 or 40 percent. The 1962 guidelines also established the use of industry classifications, as distinct from classifying assets by type of assets.

The lives selected for use under the guidelines were determined by reference to the useful lives claimed by the taxpayers surveyed and generally the lives selected were the useful lives equal to the lives being claimed by the taxpayers at the 30th percentile—that is 29 percent of the assets had shorter lives and 70 percent had longer lives,

The guidelines also contained a reserve ratio test which was designed to assure that taxpayers would not be permitted continually to depreciate their assets over a period of time substantially shorter than the period of actual use. Basically, the reserve ratio test assumes that the actual useful life of assets can be determined by comparing the amount of depreciation reserves to the acquisition costs of the assets being depreciated. Such comparison is known as the reserve ratio. A built-in tolerance was contained in the reserve ratio test to assure that the test would be met in the cases of taxpayers depreciating their assets at a rate not more than 20 percent faster than the period of their actual use of such assets.

The application of the reserve ratio test was initially suspended for three years. In 1965, the reserve ratio test was substantially modified and new transitional rules were added which had the effect of further delaying the application of the test in most cases until about the present time. When the Treasury Department adopted its Asset Depreciation Range System ("ADR") earlier this year, it completely eliminated the reserve ratio test for 1971 and future years.

In addition to removing the reserve ratio test, the ADR system contains the following basic elements:

1. A first year convention is provided under which taxpayers generally are permitted to take three-fourths of a full year's depreciation for the year in which an asset is placed in service. This is accomplished by allowing a taxpayer to treat all assets placed in service during a year as placed in service on the first day of the second quarter of the year for depreciation purposes. Under the prior conventions, taxpayers generally were allowed to take only a half year's depreciation on assets placed in service during the year.

2. Taxpayers are permitted to vary the period over which they depreciate assets by as much as 20 percent from the guideline lives established in 1962. The assets subject to the ADR system are to be accounted for in so-called "vintage accounts", which include all the eligible depreciable assets placed in service by a taxpayer in a year for which an ADR election is made. A taxpayer electing the system is required to include in his income tax return a schedule showing acquisitions and retirements with respect to each vintage account. The information supplied will include the type and age of equipment retired. Accordingly, it is anticipated that the Internal Revenue Service will receive regular and complete data with respect to the period of time over which assets are actually used. This type of data, unavailable under prior practice, will in the future permit accurate estimates to be made of the actual use of property on the basis of which useful lives may be projected.

3. The ADR system continues the prior practice of permitting taxpayers to exclude the salvage value of property in determining their annual depreciation deduction, so long as the property is not depreciated below its salvage value. Additionally, ADR provides a tolerance limit within which a taxpayer's estimate of salvage value will not be challenged. Generally, the taxpayer's estimate will not be challenged if the proposed adjustment is not more than 10 percent of the cost of the property, but if it is more than 10 percent, the entire adjustment including the 10 percent is to be made.

4. Taxpayers are permitted to elect to use a repair allowance to determine the amount of repair expenses and specified repair or improvement expenditures (which might otherwise be treated as capital expenditures) that may be deducted currently. The amount of these items which may be deducted currently is determined by applying the applicable repair percentage prescribed for the guideline class to the cost of the assets in the class. The total amount of these items in excess of the currently deductible amount must be capitalized.

5. The depreciation modifications provided in the ADR regulations in the case of certain categories of utilities (such as telephone, elec-

tric and gas pipeline companies) is to be available only if they "normalize" the tax deferral obtained thereby for ratemaking purposes. (By "normalize" it is meant that they must for ratemaking purposes show as costs the taxes which would have been incurred in the absence of the provision for shorter useful lives and then gradually reduce these costs as the regular guideline lives would have permitted the depreciation. This treatment with respect to "normalization" is substantially similar to that provided in the Tax Reform Act of 1969 with respect to accelerated depreciation methods.)

6. It is provided that gain on ordinary retirements of assets from a depreciation account is not to be recognized until the reserve for depreciation exceeds the basis of the account and that loss on such retirements is not recognized until the account is closed.

Problems in general.—The three-quarter year convention contained in the ADR system is essentially an incentive to business investment in that it provides an additional allowance in the year property is placed in service. This is, of course, the purpose which is served by the investment credit which the committee is making available. Your committee does not believe that it is appropriate to provide this double incentive to business investment and, accordingly, it has eliminated the three-quarter year convention.

Your committee is also concerned with the fact that at the present time there are in effect 3 systems for determining the useful life of property for depreciation purposes: the ADR system, the guideline lives, and the actual life of property to the taxpayer as determined on the basis of his own facts and circumstances. It appears to your committee that a desirable simplification of the depreciation rules would be achieved if the ADR system and the guideline lives were combined. Accordingly, your committee's bill provides for a class life depreciation system which is to replace both ADR and the guideline lives for property placed in service after 1970. In general, under the class life system, the Treasury Department is given authority to prescribe class lives based on anticipated industry norms (or norms based on other classes) and to permit taxpayers to elect the application of the system. If they elect to use the system, the Internal Revenue Service may permit depreciation lives within a range of 20 percent above or below the class life. The committee recognizes that many of the elements contained in the ADR system (including the repeal of the reserve ratio test) are designed to achieve significant simplifications in the administration of the depreciation rules by substantially limiting the number of situations in which disputes are likely to arise based on the particular facts and circumstances of the individual taxpayer's situation. It is contemplated that these elements of the ADR system will be incorporated by the Treasury into the class life system provided by your committee's bill.

Provision for class lives.—The bill provides a unified system of class lives which may be elected by taxpayers for assets placed in service after 1970. A taxpayer which elects to determine the useful life of assets it acquires during a taxable year under this class life system must use the system for all assets acquired during the year which fall within any class for which the Treasury has established a class life. The Treasury may permit taxpayers to use a useful life for one or more classes of property which varies from the class life by up to 20 percent. (In determining the limitation of this variance, lives may be rounded to the nearest half year).

In prescribing the lives of property within a specified class, the Treasury is to determine a life which reasonably reflects the anticipated useful life of the class of property in question to the industry (in the case of an industry or sub-industry classification) or other group (in the case of an asset or other type of classification). Initially, it is intended that the new class lives will be the same as those prescribed by the 1962 guideline lives. As the Treasury Department collects and analyzes data regarding the useful life of property to taxpayers, it may adjust the class life it has prescribed in order to reflect in general the lives used by taxpayers in the 30th percentile. As previously indicated, this was in general the basis on which the guideline lives were established.

Under the class life system, the Treasury also may redefine or subdivide the classes of property both in order to provide a more reasonable classification for depreciation purposes and also as is required for the effective functioning of the new system. For example, a separate class could be established for used property and for foreign property.

An election by a taxpayer to use the class life system is to be subject to the conditions prescribed by the Treasury Department. In general, it is contemplated that conditions substantially similar to those provided in the ADR system will be prescribed by the Treasury with respect to the class life system. Thus, a taxpayer will be required to elect the use of the class life system for a taxable year by the time the return for that year is required to be filed. A taxpayer who does not make an election during this period of time may not avail himself of any class or guideline life but rather must demonstrate the actual anticipated useful life of each of its assets (or asset accounts). An election to come under the system for a taxable year may not be changed or revoked once it is made. A taxpayer which elects the class life system may with respect to property leased by it depreciate the property on the basis of the appropriate class life (without regard to the period of the lease).

In addition, it is intended that a taxpayer who elects the class life system be required to use vintage accounts as in ADR and to provide to the Treasury the type of information required under the ADR system. Other elements of the ADR system which it is contemplated will be incorporated in the class life system include the treatment of salvage value (both the provision that salvage value does not affect the rate of depreciation, but rather limits the total amount of depreciation which may be claimed, and also the tolerance limits within which adjustments to a taxpayer's estimates of salvage value will not be challenged), the treatment of public utilities, and the treatment of retirements, under which generally the recognition of gain or loss on ordinary retirements is postponed. The treatment of retirements in this manner, of course, is not to affect the application of the investment credit recapture rules when property is disposed of.

First year convention.—As indicated above, your committee's bill, eliminates the three-quarter year convention provided under the ADR system. It does this by providing that no first-year convention is to be

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allowed for depreciation purposes if the convention would generally allow a greater amount of depreciation for the year assets are placed in service than the depreciation which would be allowable if it was computed without regard to any convention. In applying this test to determine whether a convention is permissible, it is to be applied on the assumption that all assets were acquired ratably throughout the year. Thus, for example, a convention which for depreciation purposes treats all property placed in service during the first half of the year as placed in service at the beginning of the year and all property placed in service during the second half of the year as placed in service at the end of the year would be permissible. Similarly, a convention which treats all property placed in service during a year as placed in service at the mid-point of the year for depreciation purposes would be permissible.

Repairs allowance.—Your committee's bill also provides that the Treasury Department may, by regulations, provide for the treatment of repairs. To provide a means of resolving the disputes which frequently arise as to whether an item constitutes a deductible repair expense or a nondeductible capital expenditure, it is provided that the Treasury may prescribe repair allowances for classes of depreciable property which reasonably reflect the anticipated repair experience with respect to the class of property in the industry or other group. The repair allowances are to be developed and modified by the Treasury on the basis of data collected by it regarding the repair experience of the industry or other group with respect to the class of property. Initially, it is expected that the repair allowances prescribed by Rev. Proc. 71–25 will be used. It is expected that the Treasury will have the same authority to provide classes for this purpose as with the class life system of depreciation.

A taxpayer permitted to elect the use of the repair allowance will be allowed to deduct, up to the amount of the repair allowance for the class of property, the aggregate of the amounts incurred by the taxpayer as repair expenses and as specified expenditures (ordinarily chargeable to capital account) for the repair, maintenance, rehabilitation, or improvement of the class of property.

If the amounts incurred by the taxpayer for these purposes exceeds the repair allowance, then the excess is to be capitalized. It is not intended, however, that expenditures which are clearly of a capital nature, such as, those which substantially increase the productivity or capacity of an existing identifiable unit of property or those which modify an existing identifiable piece of property to make it usable for a substantially different use are to be treated as deductible expenses under this provision rather than as capital expenditures. In other words, these latter types of expenditures are in all events to be capitalized and not taken into account under the repair allowance provision.

Effective dates.—The class life depreciation system provided by the bill is to be applicable with respect to property placed in service by the taxpayer after December 31, 1970. In situations where a taxpayer's return for a taxable year which includes January 1, 1971, has been filed prior to, or shortly after, the enactment of the bill, it is intended that the Treasury Department will allow a reasonable period of time after the enactment of the bill for the taxpayer to elect the application of the class life system (whether or not the taxpayer elected the application of the ADR system for that year).

Although the class life system is not applicable with respect to assets placed in service prior to January 1, 1971, the Treasury Department may provide an elective guideline life system for such assets similar to the class life system.

The repair allowance provision contained in the bill is to apply to taxable years ending after December 31, 1970.

Useful lives for real property.—During your committee's consideration of depreciation and useful lives, its attention was called to the useful lives prescribed for real estate under the 1962 guideline program. Your committee believes that in connection with its review of the useful lives of tangible personal property, it is also desirable to make a study of the lives accorded various types of real property, and therefore it is requesting the Treasury Department to undertake such a review. In this connection your committee believes that it is also desirable to consider whether, if lives are shortened, the recapture rules presently applicable in the case of real property should be made more like those applicable to personal property.

12. Revenue effect

It is estimated that the elimination of the three-quarter year depreciation convention will increase tax liabilities by $2.1 billion in calendar year 1971, $1.7 billion in calendar year 1972 and $1.5 billion in calendar year 1973. The restoration of the investment credit is estimated to decrease tax liabilities by $1.5 billion in calendar year 1971, $3.6 billion in calendar year 1972, and $3.9 billion in calendar year 1973.

B. Individual Income Tax Reductions

1. Increase in the personal exemption (secs. 201 and 205 of the bill and secs. 151 and 21 of the code)

Under present law, the amount of the personal exemption is $650 for calendar year 1971 and is scheduled to increase to $700 for 1972 and to $750 for 1973 and later years. The increased amounts apply to the personal exemptions available to taxpayers, their spouses and dependents, as well as to the additional exemptions available in the case of blindness and for a taxpayer age 65 or over.

Your committee concluded that as part of the program to stimulate the economy, the increase in the personal exemption scheduled for 1973 should be moved up to 1972 and that the exemption amount for 1971 should be increased. The increase in the exemption for 1971 and the acceleration of the 1973 exemption increase to 1972 will provide immediate economic stimulus by making additional funds available to consumers. Moreover, the tax relief this provides to lower- and middle-income taxpayers is accomplished without creating any long-term revenue loss as compared to present law. The increase in the 1971 exemption also will offset to some extent the underwithholding for 1971 created by the present withholding system (discussed below under "Withholding changes"), and thus will ease the burdens faced by taxpayers when the balance of their 1971 tax must be paid next year.

The bill increases the amount of the personal exemption for calendar year 1971 from the present $650 to $675 (the equivalent of increasing it to $700 effective July 1) and further increases it to $750 for 1972 and subsequent years. The tax reduction for illustrative taxpayers from the higher personal exemption, changes in the low-income allowance and in the percentage standard (discussed below) are shown in Tables 8 and 9 in the Statistical Appendix. For taxpayers with fiscal years the applicable personal exemption is determined by a proration rule which takes into account the number of days in the taxable year falling in each calendar year.

The tax decrease from the higher personal exemption is estimated to be $925 million for calendar year 1971 and $1.8 billion for 1972. It does not, however result in any additional revenue loss for 1973 and subsequent years.

2. Increase in the low-income allowance and the percentage standard deduction (secs. 202 and 203 of the bill and sec. 141 of the code)

Under present law, the low-income allowance is $1,050 for 1971, but a portion of the low-income allowance is reduced or "phased out" by $1 for every $15 of the taxpayer's income in excess of the tax-free income levels. In 1972 and thereafter, the low-income allowance is scheduled to be $1,000 with no "phaseout." The percentage standard deduction under present law for 1971 is 13 percent of adjusted gross income with a $1,500 ceiling and is scheduled to increase to 14 percent with a $2,000 ceiling for 1972 and to 15 percent with a $2,000 ceiling for 1973 and subsequent years.

The low-income allowance (or minimum standard deduction) was designed so that in conjunction with the personal exemption, it would free persons with incomes below the estimated "poverty level" from income tax. Because rising prices have increased the poverty level, the $1,000 low-income allowance in combination with the $750 personal exemption provides a tax-free income level which is significantly below the poverty level. This can be seen in Table 7 below which shows the estimated poverty level for 1972 for different size families as compared to the tax-free income level provided by the $1,000 low-income allowance and the $750 personal exemption. For example, the poverty level for a single person is estimated to be $2,170 in 1972 compared to the tax-free level of $1,750 which would be provided for that year by the $750 personal exemption and the $1,000 low-income allowance. For a married couple, the 1972 poverty level is approximately $2,800 compared to the $2,500 tax-free level available with the $750 personal exemption and $1,000 low-income allowance for that year.

To bring the tax-free income levels up to the 1972 poverty level in almost all cases, and also to provide tax relief to lower income persons above the poverty levels, your committee concluded that the low-income allowance should be increased to $1,300. As shown in Table 7 below, the tax-free income level provided by the bill for a single person in 1972 will be $2,050 (compared to the estimated poverty level of approximately $2,170). For a married couple with no dependents, the tax-free level will be $2,800 (compared to the poverty level of approximately $2,800); and for a family of four, the tax-free level of $4,300 available with the $1,300 low-income allowance is almost exactly equal to the estimated poverty level for 1972 of $4,290.

TABLE 7.—POVERTY INCOME LEVELS AND TAX-FREE INCOME LEVELS UNDER 2 LOW-INCOME ALLOWANCE LEVELS BY FAMILY SIZE

Number in the family	Estimated 1972 poverty level	Tax-free income level with $750 exemption and— $1,000 allowance	$1,300 allowance
1	$2,170	$1,750	$2,050
2	2,810	2,500	2,800
3	3,350	3,250	3,550
4	4,290	4,000	4,300
5	5,050	4,750	5,050
6	5,680	5,500	5,800

The increase in the low-income allowance provided by the bill also will generate more economic stimulus per dollar of individual income tax reduction than would other forms of tax relief. This is because the tax reduction resulting from the low-income allowance will go to those at the lower income levels who are likely to spend virtually all of it.

In addition to providing individual tax relief for future years, your committee concluded that it would be desirable to provide tax reductions for 1971 for lower income taxpayers by removing the phaseout on the low-income allowance for 1971. (This is in addition to the exemption increase referred to previously.) Moreover, the reduction in tax liability for 1971 resulting from the removal of the phaseout will offset some of the underwithholding in that year (discussed below in "Withholding changes"). In addition to increasing the personal exemption and the low-income allowance for 1972, your committee believes it is desirable to accelerate to 1972 the other remaining change scheduled for 1973; namely, the increase in the percentage standard deduction from 14 to 15 percent. This will provide additional tax relief to low- and middle-income taxpayers and also will provide additional simplification for 1972 by causing a substantial number of taxpayers to switch from itemizing their deductions to claiming the standard deduction.

The bill removes the "phaseout" on the low-income allowance for calendar year 1971, making it a flat $1,050. For 1972 and thereafter, the bill provides a low-income allowance of $1,300 and a percentage standard deduction of 15 percent of adjusted gross income with a $2,000 ceiling. The increase in the low-income allowance to $1,300 will provide tax reductions for 25 million returns relieving 1.9 million from tax. Filers of 2.2 million returns are expected to switch from itemizing their deductions to the standard deduction. The tax reduction for illustrative taxpayers in 1971 from the combination of the $25 increase in the personal exemption and the removal of the phaseout on the low-income allowance is shown in Tables 8 and 9 in the Statistical Appendix. The tax reduction for these illustrative taxpayers in 1972 from the $750 personal exemption, the $1,300 low-income allowance, and the 15 percent standard deduction is also shown in Tables 8 and 9 in the Statistical Appendix.

The reduction in tax for 1971 from the removal of the phaseout on the low-income allowance is estimated to be $443 million. (The combined tax reduction from the increase in the personal exemption and the removal of the phaseout on the low-income allowance for 1971 is estimated to be $1,368 million.) The increase in the low-income allowance to $1,300 is estimated to provide a tax reduction of $992 million for 1972. The combined tax reduction for 1972 from the $1,300 low-income allowance, the increase in the amount of the personal exemption to $750, and the increase in the percentage standard deduction from 14 to 15 percent is estimated to be $3,083 million.

3. Filing requirements (sec. 204 of the bill and sec. 6012(a) of the code)

Under present law, the income level at which a tax return must be filed is designed to correspond to the tax-free income levels. The level for 1971 and 1972 is $1,700 for a single taxpayer and $2,300 for a married couple under age 65 (or a single person age 65 or over), $2,900 for a married couple where only one spouse is age 65 or over, and $3,500 where both spouses are age 65 or over. For 1973 and thereafter, these income levels are scheduled to be further increased to $1,750, $2,500, $3,250 and $4,000, respectively, to reflect the scheduled increase of the personal exemption to $750 in that year.

Since the increase in the low-income allowance to $1,300 is not taken into account in the filing requirement levels provided under present law, the tax-free income level for 1972 will be $300 higher than the filing requirement levels which otherwise are to be applicable in that year. Consequently, it is necessary to raise those levels to avoid the filing of returns by individuals whose income is below the taxable level.

For 1972 and thereafter, the bill increases the income level at which a tax return must be filed to $300 above the level provided by present law for 1973. Accordingly, the filing requirement is to be $2,050 for a single person, $2,800 for a married couple (or a single person age 65 or over), $3,550 for a married couple where one spouse is age 65 or over, and $4,300 for a married couple when both spouses are age 65 or over.

4. Waiver of penalty for underpayment of 1971 estimated income tax (sec. 207 of the bill and sec. 6654 of the code)

Under present law, individuals are required to pay estimated income tax if they expect more than $200 of non-wage income generally or if they expect a gross income of more than $5,000 in the case of a single person or $10,000 in the case of a married couple. If such a taxpayer's estimated tax payments (including taxes withheld) are less than 80 percent of the tax due (as shown on his return), a 6-percent penalty is imposed on the amount of the underpayment (which is the difference between the tax paid and 80 percent of the tax due).

Because of the underwithholding problems created by the Tax Reform Act of 1969, many taxpayers who have not previously paid estimated tax may find that they have an unexpected balance due when they file their 1971 returns (this is discussed below in "Withholding changes") which is substantial enough to cause the imposition of the 6-percent underpayment penalty. Your committee concluded that since much of this underwithholding was unexpected and was caused by the withholding system which these taxpayers generally rely on, it would be unfair to impose the additional tax penalty on this underwithholding.

The bill provides that the penalty for underpayment of estimated income tax for individuals is not to apply for 1971 in the case of certain calendar year taxpayers. Generally, those taxpayers for whom the penalty is waived are single persons (or married persons not entitled to file a joint return) whose gross income does not exceed $10,000, married individuals entitled to file a joint return if their combined income is less than $20,000, and heads of households and surviving spouses if their gross income does not exceed $20,000. The waiver does not apply, however, if the taxpayer had more than $200 ($400 in the case of married taxpayers) in income from sources other than wages.

The waiver of penalty applies to the taxable year beginning after December 31, 1970, and ending before January 1, 1972.

5. Withholding changes (sec. 208 of the bill and sec. 3402 of the code)

Present law provides a percentage withholding method for 1971, 1972, and 1973, which incorporates the personal exemption, the low-income allowance and the percentage standard deduction provided by present law for those years. Wage bracket withholding tables based on the percentage method are prescribed by the Secretary of the Treasury.

Because of the increase in the low-income allowance to $1,300 for 1972 and the acceleration of the increases in the personal exemption and the percentage standard deduction scheduled for 1973 to 1972, it is necessary to change the withholding rates to reflect these changes. In addition, the present withholding structure does not withhold a sufficient amount in many instances. The principal sources of this underwithholding are: (1) the incorporation of the low-income allowance into the withholding structure results in a married couple receiving two low-income allowances for withholding purposes when both spouses work, whereas they are entitled to only one on their tax return (the same problem also occurs where a person works for more than one employer at the same time); (2) the $2,000 ceiling on the percentage standard deduction is not reflected in the withholding rates so that a taxpayer whose standard deduction is limited by the ceiling will have too little tax withheld; and (3) the top withholding rates are not high enough.

Your committee concluded that it is desirable to correct these sources of underwithholding by adopting a new withholding system. In order to avoid too large an increase in withholding at one time, however, your committee decided to implement only part of the new withholding structure in 1972 and defer the remainder until the beginning of 1973.

The bill provides new withholding rates which reflect the $750 personal exemption, the $1,300 low-income allowance and the 15-percent standard deduction. In addition, the bill changes the withholding structure to eliminate the underwithholding caused by the low-income allowance. This is done in two stages in order to avoid a large increase in withholding and reduction in take home pay at one time.[1]

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[1] Because of the effect of the $1,300 low-income allowance on the withholding brackets, some withholding rates above the level where the low-income allowance applies are increased, particularly for single persons, in the first stage.

The new withholding structure provided by the bill has a bottom bracket of $550 to which a zero rate applies in place of the $1,000 bracket of present law. In the first stage of the withholding change, a single person or a married taxpayer will be able to have the full $1,300 low-income allowance taken into account for withholding purposes by claiming a "standard deduction allowance" on the withholding certificate (W-4) filed with his employer. In this case, this result is obtained by allowing an additional $750—referred to as a standard deduction allowance—which may be claimed by either the husband or wife but not by both (where both are working). This plus the bottom $550 zero rate bracket provides assurance that income will not be subject to withholding below the $1,300 low-income allowance level. The same amount will be available to a single person. This system will still result in some underwithholding where both the husband and wife are working since each has a $550 zero bottom rate bracket and these plus the extra $750 provide an exclusion for $1,850 ($550+$550+$750) instead of $1,300. There will also be underwithholding for the same reason if a person works for more than one employer at the same time and claims a "standard deduction allowance" with one employer. This problem is dealt with in the second stage of the withholding changes.

Another source of underwithholding which is corrected in the first stage of the withholding change is the practice of taxpayers claiming withholding exemptions with more than one employer at the same time. The result of this is in effect to allow exemptions twice. For example, a single individual who claims a $750 exemption with each of two employers can have as much as $1,500 exempt from withholding on account of exemptions even though he is entitled to only one $750 exemption on his tax return. The bill deals with this source of underwithholding by instructing an employee not to claim the same withholding exemptions with more than one employer at a time.

The first stage of the withholding change applies to wages paid and withholding certificates filed after November 14, 1971, and before January 1, 1973. This withholding change is expected to increase withholding by approximately $500 million in calendar year 1972.

In the second stage of the withholding system change (applicable to wages paid after December 31, 1972) a married taxpayer will not be allowed to claim an extra $750 "standard deduction allowance" if his spouse is also an employee receiving wages subject to withholding. In that case, the taxpayer and his spouse will each have the bottom withholding bracket amount of $550 exempt from withholding, a total of $1,100. This is $200 less than the $1,300 low-income allowance and would tend to create overwithholding. This tendency, however, is partly or wholly offset by the fact that when two earners combine their income on the tax return, it is generally subject to higher tax rates than the withholding rates applicable to the separate earnings of each spouse. In addition, a taxpayer will not be allowed to claim the "standard deduction allowance" if he has withholding exemption certificates in effect with more than one employer.

To correct the underwithholding caused by the lack of a standard deduction dollar limit and the inadequate top withholding rates, the second stage of the withholding change, in effect, incorporates the

$2,000 ceiling on the percentage standard deduction by increasing the appropriate withholding rates. In addition, a seventh withholding bracket is added and the withholding rates generally are adjusted upward. These changes will result in withholding the full amount of tax liability up to a wage level of approximately $25,000 for a single person and $31,000 for a married couple (with only one spouse working) compared to the level of about $13,500 in each instance under present law. (These levels assume the standard deduction.)

The second stage withholding changes are estimated to increase tax withheld by an additional $1.5 billion in calendar year 1973 before taking account of any offsetting adjustments. To the extent that taxpayers use the provision for excess itemized deductions (discussed below) or reduce their voluntary overwithholding correspondingly, the $1.5 billion could be reduced or eliminated entirely.

In conjunction with the second stage withholding changes, the provision of present law which permits a taxpayer with large itemized deductions to avoid overwithholding is changed by permitting an additional withholding allowance for each $750 of itemized deductions in excess of 15 percent of estimated wages or $2,000, whichever is less. This provision is also liberalized to make it easier to use. (This change is effective for wages paid after December 31, 1971.) Under present law, a taxpayer's estimate of his itemized deductions for the current year generally may not exceed the deductions claimed on his tax return for the preceding taxable year or, if he has not yet filed his tax return for the preceding year, the second preceding year. After April 30 of the current year, or after he has filed his tax return for the preceding year, however, the estimated deductions may not exceed those of the preceding year. If a taxpayer wishes to reduce his withholding under this provision, it is preferable for him to take advantage of the provision at the beginning of the year. The above rule may, however, require him to file a second exemption certificate during the year. This seemed unnecessarily restrictive to your committee and is likely to deter taxpayers from making use of the provision. Consequently, the bill provides that a taxpayer who has not yet filed his return for the preceding year must limit his estimated deductions to the amount claimed for the second preceding year but need not file a new exemption certificate after filing his return, even if the itemized deductions for the preceding year are less than those of the second preceding year.

In addition, the bill provides that the additional allowances are to remain in effect until the taxpayer files a new withholding exemption certificate with his employer because of a change in circumstances (which the employee is required to do). Under present law, the additional allowances are not effective after April 30 of the following year.

6. *Declaration of estimated tax* (*sec. 209 of the bill and sec. 6015*(*a*) *of the code*)

Under present law, individuals are required to file a declaration of estimated tax and pay the tax in installments if they expect their tax not covered by withholding to be $40 or more and either expect to have income from sources other than wages of more than $200 or expect their gross income to exceed certain amounts. These amounts are \$5,000 for a single person or a married person not entitled to file a joint return and \$10,000 for a married couple entitled to file a joint return, a head of household and a surviving spouse.

The withholding system of present law provides sufficient withholding to match tax liability in most cases at income levels substantially above the income levels at which a declaration may be required under present law. In addition, the higher withholding rates provided by the bill for 1973 and thereafter (discussed above in "Withholding changes") will increase the income levels at which withholding will match tax liability. Consequently, your committee concluded that it would be appropriate to raise the income levels above which a declaration is required to conform to the new withholding structure. In addition, your committee believes that the \$40 of final tax payment requirement should be raised, since this amount no longer presents the same difficulty for the taxpayer or the Internal Revenue Service as it once did. For similar reasons, it is believed that the \$200 of income from sources other than wages (which implies approximately a \$40 tax in the lower tax brackets) also should be updated.

The bill increases the income level at which a declaration must be filed to \$20,000, for a single person, a head of household and a surviving spouse, and a married individual whose spouse does not receive wages. The income level remains at the \$10,000 amount of present law in the case of a married couple where both spouses receive wages because the withholding system does not match withholding and tax liability at as high a level in the case of two earners. A declaration is also required if gross income is expected to include more than \$500 of income from sources other than wages. No declaration of estimated tax is required, however, if the estimated final payment is expected to be less than \$100.

These changes apply to estimated tax for years beginning after December 31, 1972.

C. Structural Improvements

1. Standard deduction and personal exemption of individual receiving certain trust income (sec. 301 of the bill and sec. 280 of the code)

Under present law, the standard deduction and the deduction for a personal exemption are available to a taxpayer regardless of the source of his income. The attention of your committee has been called to cases where taxpayers, by temporarily transferring property to a trust for a dependent, utilize the dependent's personal exemption and standard deduction as a means of reducing the tax on income generated by the property transferred. The temporary nature of the transfer in these cases is assured by using trusts with the grantor retaining a reversionary interest. In this manner, a grantor may remove the income from property from his tax base, yet retain a continuing interest in the property (often providing that the trust corpus is to revert to him after 10 years). Moreover, because of the significant increases in the size of the standard deduction (including the minimum standard deduction) and the personal exemption available to the dependent in recent years, this has become an increasingly significant way of avoiding tax without imposing tax on the dependent.

Your committee believes that the use of the standard deduction (including the minimum standard deduction) and the personal exemption in this manner is not appropriate.

As a result, the bill provides that an individual receiving certain trust income is not to be able to use his personal exemption or the standard deduction to offset income received by him from the trust. He can, however, utilize this deduction and exemption against other income.

The bill provides that two conditions must be present before the individual receiving trust income is denied the deduction and exemption. First, the individual must be required to include in income for a taxable year (under the normal rules relating to the income taxation of trusts) the distributable net income of a trust in which the grantor (or his spouse) has as of the close of that year any interest in either the income or the corpus of the trust.

The reversionary interest retained by the grantor or the remainder interest of his spouse in this case must exceed 5 percent of the value of the corpus of the trust at the time of the transfer in trust. In making this computation, the value of the property interests in the trust property possessed by the grantor and his spouse are aggregated.

The second requirement under this provision is that the taxpayer receiving the trust income bear a relationship to the trust grantor which is described in paragraphs (1) through (8) of section 152(a) of the code. It is not necessary that the beneficiary be a "dependent" as that term is defined in the code but, simply, that the beneficiary be in one of the following degrees of relationship to the grantor:

(1) a son or daughter of the taxpayer, or a descendant of either,

(2) a stepson or stepdaughter of the taxpayer,

(3) a brother, sister, stepbrother, or stepsister of the taxpayer,

(4) the father or mother of the taxpayer, or an ancestor of either,

(5) a stepfather or stepmother of the taxpayer,

(6) a son or daughter of a brother or sister of the taxpayer,

(7) a brother or sister of the father or mother of the taxpayer,

(8) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the taxpayer.

Under the retained interest condition, it is sufficient if either the spouse or the grantor possess the continuing interest in the trust. Thus, if a father transfers property in trust for the benefit of his son for a 10-year period, with the remainder to his wife, the trust would be one with respect to which this provision applies. However, the existence of the grantor's continuing interest in the trust property is to be determined on an annual basis. For example, if the grantor (or his spouse) possessing a continuing interest in the trust property transfers his interest to another person (other than his spouse), the beneficiary of the trust would not be disallowed his personal exemption and the standard deduction under this provision for his taxable year during which the grantor (or his spouse) disposed of his interest in the trust property.

When both the continuing interest in trust property and the relationship requirement referred to above exist, the bill provides for two changes in the manner in which the percentage standard deduction and personal exemption are computed. First, the percentage standard deduction (provided in section 141(b)) is to be computed by excluding from adjusted gross income the income of the trust includable in the taxpayer's gross income. Second, the sum of the standard deduction (including the low-income allowance) and the taxpayer's personal exemption are to be limited to the adjusted gross income of the taxpayer computed by excluding the income received by him from the trust.

For example, assume that a taxpayer in 1972 receives $10,000 in income from a trust to which this section applies and $1,900 in adjusted gross income which is unrelated to the trust. This provision prevents the taxpayer from computing his percentage standard deduction by taking into consideration the income received by him from the trust. Therefore, the taxpayer would not be entitled to compute his standard deduction by taking 15 percent of $11,900. In addition, the taxpayer's personal exemption and standard deduction for the taxable year are to be limited to his nontrust adjusted gross income. Consequently, the taxpayer in this situation would not be entitled to a full $750 personal exemption and a $1,300 low-income allowance. However, his personal exemption and standard deduction could equal his nontrust adjusted gross income, or $1,900.

These provisions will also apply to income "thrown back" under the accumulation trust provisions (secs. 665–669 of the code). Thus, the grantor may not escape the provisions by establishing a trust to accumulate income for 10 years and then to distribute it to the related beneficiary. In such a case the code (sec. 668(a)) requires that the beneficiary's tax be computed by either the "exact" method (sec. 668 (b)(1)(A)) or the "short-cut" method (sec. 668(b)(1)(B)). Both of these provisions require recomputation of the beneficiary's tax for one or more of his prior taxable years. If, in such prior taxable year, this provision would have applied had the trust income been distributed currently, it will also apply to the recomputation under the throwback rules.

This provision applies to property transferred in trust after September 22, 1971, but only with respect to taxable years beginning after December 31, 1971.

2. Limitation on carryovers of unused credits and capital losses (sec. 302 of the bill and sec. 383 of the code)

Under present law, there are special limitations on net operating loss carryovers when the ownership of a corporation changes either because of a purchase or because of a reorganization. The code provides (sec. 382(a)) in general that if 10 or fewer persons acquire more than 50 percent of the stock of a corporation by purchase within a 2-year period, the net operating loss carryover is eliminated if the corporation does not continue to carry on a trade or business substantially the same as that conducted before the change in stock ownership. In addition, if a corporation which has a net operating loss carryover (a "loss corporation") is acquired by another corporation in a tax-free reorganization, the net operating loss carryover is reduced unless the shareholders of the loss corporation receive at least 20 percent of the stock of the acquiring corporation (as measured immediately after the acquisition). In such a case, the percentage of the loss carryover which is allowed is five times the percentage interest acquired by the shareholders of the loss corporation.

These limitations, however, do not apply to carryovers of unused investment credits, of excess foreign tax credits, or of capital losses. Thus, the tax benefits of these carryovers may at the present time be purchased or acquired by the acquisition of a corporation having these types of carryovers. Your committee does not believe there is any greater justification for allowing the acquisition of these benefits than there is in the case of net operating loss carryovers.

Accordingly, your committee's bill provides that the limitations of present law which apply to carryovers of net operating losses in situations where a loss corporation is acquired also are to apply (in the manner provided under regulations prescribed by the Secretary or his delegate) to situations involving carryovers of unused investment credits, of excess foreign tax credits, and capital losses of the acquired corporation.

This provision is to apply with respect to reorganizations and other changes in ownership occurring after the date of enactment of the bill.

3. Amortization of certain expenditures for on-the-job training and child care facilities (sec. 303 of the bill and sec. 188 of the code).

Present law provides a deduction for depreciation of tangible property (except land) used in a trade or business or held for the production of income. Under this provision, tangible property acquired by an employer in his business as an on-the-job training facility or as a child care facility for his employees, is depreciable in the case of new personal property (i.e., machinery and equipment)on the basis of the double-declining balance method and in the case of new real property (i.e., buildings and structures) on the basis of the 150-percent declining balance method of depreciation.

Prior to April 18, 1969, the taxpayer could also claim the 7-percent investment tax credit for new depreciable tangible personal property (and to the extent of $50,000 for used property). Under this bill, for the future, the investment credit can also be claimed for tangible personal property. The credit, however, is not generally available for depreciable real property.

Your committee recognizes the need for job training programs as a means of providing additional employment opportunities for persons with inadequate training. It also recognizes the need to provide child care facilities within the financial means of those with low incomes in order to enable and encourage persons to seek employment. The Congress has recognized the need for both of these types of programs by enacting public programs in both of these areas.

Your committee believes, however, that it is also important to encourage private business to provide facilities for such programs. On-the-job training experience is believed to be the most effective and productive type of training for many jobs, as the person gains actual work experience during the training. Moreover, the person is more likely to complete the training if a job is available at the end of the training. There also is the need for additional child care facilities at the place of employment, since this would be likely to be more convenient for the employee. A recent study by the Women's Bureau in the Department of Labor [1] reported, however, that only a small number of employers and employee unions have established child care centers.

To meet the needs described above, the bill adds a new provision to the tax law providing that a taxpayer may elect, in accordance with regulations prescribed by the Secretary or his delegate, to amortize ratably over a period of 60 months capital expenditures in acquiring, constructing, reconstructing or rehabilitating on-the-job training or child care facilities. The amortization is to begin with the month the property is placed in service and the deduction provided is to be in place of any depreciation deduction otherwise allowable. The bill defines eligible property as depreciable tangible property which qualifies under regulations as an on-the-job training facility for employees (or prospective employees) of the taxpayer or as a child care facility primarily for children of the taxpayer's employees. Eligible property, however, does not include property located outside the United States. In addition, the amortization is available only with respect to qualified expenditures made after December 31, 1971, and before January 1, 1977. This latter provision will give Congress an opportunity to review the effectiveness of the provision after it has been in effect for five years.

The bill amends the code to provide that gain realized on the disposition of property eligible for amortization under this provision is to be subject to the recapture rules (of sec. 1245) to the extent of the amortization deductions taken under this provision. The bill also amends present law (sec. 57) to provide that the amount by which the amortization deductions exceed depreciation deductions otherwise allowable (including, for this purpose, accelerated depreciation deductions) is to be treated as a tax preference for purposes of the minimum tax. This is consistent with the policy Congress has generally followed with respect to amortization deductions. The bill also makes necessary conforming amendments (to secs. 642 and 1082) to provide for the treatment of amortization deductions in the cases of estates and trusts, and exchanges made in obedience to Securities and Exchange Commission orders.

An amendment (to sec. 48) also provides that if an election is made under this provision, the property involved is not to be treated as property eligible for the investment credit.

The amendments of the bill dealing with the amortization of expenditures for on-the-job training and child care facilities are applicable to taxable years ending after December 31, 1971.

4. Definition of net leases (sec. 304 of the bill and secs. 57 and 163 of the code)

Under present law, two of the tax preference items subject to the minimum tax on tax preferences in the case of individuals (and subchapter S corporations and personal holding companies) are accelerated depreciation on personal property subject to a net lease and "ex-

[1] "Day Care Services: Industry's Involvement," Bulletin 296 (1971).

cess investment interest". In the latter case, property subject to a net lease is considered as property held for investment (and thus any interest paid with respect to the property is considered investment interest). Excess investment interest is not to be treated as a tax preference item for taxable years beginning after 1971, but instead a limitation is imposed on the extent to which it is currently deductible.

One of the tests provided in present law for determining whether a lease is a net lease for purposes of these provisions looks to the degree of the lessor's business activity with respect to the leased property. It is provided that a lease will not be considered a net lease if the trade or business deductions arising with respect to the property are 15 percent or more of the rental income produced by the property.

It has been suggested that the provisions of present law can be avoided where the lessor has a rental deduction which means that his deductions are very likely to exceed 15 percent. A rental deduction may be involved, for example, in the case of ground rent where the building is owned by the lessor. In this case the rent paid by the lessor does not provide any measure of his business activities in connection with the leased property. As a result, it seems inappropriate to permit these items to be taken into account to determine whether the 15-percent test is satisfied. Accordingly, the bill specifically restricts the business deductions taken into account for this purpose to deductions of the lessor (other than deductions for rents with respect to the leased property).

In addition, cases have been called to your committee's attention where an individual leases property to someone else, paying all of the expenses for the care of the property, but being reimbursed for them by the lessee. In this case also, although the 15-percent test may technically be met, the lessor is not at risk with respect to the additional expenses and, therefore, has the equivalent of a net lease. As a result, the bill also provides that the business deductions of the lessor taken into account for purposes of the 15-percent test are not to include expenses for which he is reimbursed by the lessee.

Since these are the results intended by Congress, these changes are to apply in the case of the minimum tax on tax preferences to taxable years beginning after December 31, 1969 (the effective date of that tax), and in the case of the limitation on the current deduction of excess investment interest to taxable years beginning after December 31, 1971 (the effective date of that provision).

5. Farm losses of subchapter S corporations (sec. 305 of the bill and sec. 1251(b) of the code)

Under present law, farm net losses previously used by a taxpayer to offset nonfarm income are recaptured (upon the sale or other disposition of certain farm property) to the extent these losses are required to be added to the taxpayer's "excess deductions account." This account—referred to as the EDA account—provides a way of keeping a record of farm losses which are to convert subsequently realized farm capital gains into ordinary income. However, additions to this account need to be made only in a year in which an individual's nonfarm adjusted gross income is in excess of $50,000 and a farm loss is to be taken into account only to the extent it exceeds $25,000. Although no such limits are available in the case of most corporations, they do apply in the case of a subchapter S corporation (since its income is taxed to the shareholders rather than to the corporation). However, even for a subchapter S corporation, the limits do not apply in any year in which any one of its shareholders has a net farm loss for the taxable year involved.

Two potential problems in the application of the present farm loss provisions to subchapter S corporations have been brought to your committee's attention. First, it has been suggested that a subchapter S corporation with more than $25,000 in farm net losses for a taxable year (but with nonfarm income of $50,000 or less) would not be required to add any farm losses to its EDA account for the year, even though the loss was passed through to and currently deducted by a shareholder who had nonfarm income in excess of $50,000. This interpretation, of course, would permit an individual to use a subchapter S corporation to avoid the farm loss rules by separating his farming operations from his nonfarm income by placing the farm operations in a subchapter S corporation. To clarify the fact that this result was not intended by Congress, the bill provides that in determining whether a subchapter S corporation has more than $50,000 of nonfarm income—and as a result must add its farm loss (in excess of $25,000) to its EDA account—its nonfarm income and the nonfarm income of whichever of its shareholders has the largest amount of nonfarm income for the taxable year involved are to be combined. If the combined amount exceeds $50,000, then the corporation's farm net loss (in excess of $25,000) must be added to its EDA account.

The second potential problem suggested in this area involves the possible use by an individual of multiple subchapter S corporations to carry on his farm loss business. It has been suggested each subchapter S corporation would receive the benefit of not having to add the first $25,000 of its farm net loss to its EDA account even though none of the corporations would receive this benefit if the individual himself had a farm loss rather than having the loss passed through by the corporations to him. To clarify this matter, the bill denies the benefit of the $25,000 exclusion to a subchapter S corporation if anyone of its shareholders also is a shareholder of another subchapter S corporation that has a farm net loss for the year involved.

These amendments are to apply with respect to taxable years ending after the date of enactment of this Act. No inference is intended. however, to be drawn from this effective date as to the treatment of these matters for prior years.

6. Capital gain throwback (sec. 306 of the bill and sec. 665(g) of the code)

The Tax Reform Act of 1969 added a new capital gain throwback rule to the tax law applicable in the case of certain trusts. When this rule applies and a beneficiary of a trust receives a distribution consisting of capital gains accumulated in prior years (beginning after 1968), he is taxed, in general, on these amounts as though they had been distributed by the trust in the year in which the trust realized the gain. A distribution of this type is referred to as a "capital gain distribution."

The definition of the term "capital gain distribution" for any taxable year of the trust includes the phrase, "to the extent of undistributed capital gain for such taxable year, * * *." The reference here to the phrase "for such taxable year" can be interpreted as limiting to the amount of the current year's capital gains the amount of the capital gains of the trust available for a capital gain throwback to an earlier year. Under this interpretation, a trust could accumulate capital gains and then, in a later year when it had no undistributed capital gain, distribute the accumulated capital gains to a beneficiary without this resulting in tax. This is a result which would occur if the phrase "for such taxable year" is interpreted as limiting the capital gains throwback to the capital gain realized in the current year.

This interpretation is clearly inconsistent with Congressional intent and would nullify the purpose of the capital gains throwback rule. The bill amends the definition of capital gain distribution by deleting the words "for such taxable year." This deletion makes it clear that a "capital gain distribution" for a taxable year includes the total undistributed capital gain for all years of the trust beginning after December 31, 1968, and ending before the year of distribution.

Since this amendment is a clarifying amendment, it is made effective with respect to taxable years beginning after December 31, 1968.

7. Western Hemisphere Trade Corporation deduction (sec. 307 of the bill and sec. 921 of the code)

Under present law, a domestic corporation is entitled to a special 14-percentage-point deduction if it qualifies as a "Western Hemisphere Trade Corporation." A Western Hemisphere Trade Corporation is one all of whose business is done in the Western Hemisphere and 95 percent or more of whose gross income in the past 3 years comes from sources outside of the United States.

A question has been raised regarding the application of this provision in the case of a U.S. corporation doing a substantial volume of its business in the Virgin Islands. The Virgin Islands tax law generally is the so-called "mirror" of the U.S. tax law—that is, essentially its tax law is that provided by the Internal Revenue Code, except that, generally, wherever the words "United States" appear, this, in effect, is to be read as the Virgin Islands. A recent court case has held that a U.S. corporation deriving substantial income from the Virgin Islands was eligible for the Western Hemisphere Trade Corporation deduction with respect to its tax liability to the Virgin Islands. The effect of the court case in this situation could result in a tax reduction of 14 percentage points in Virgin Islands tax liability for U.S. businesses with substantial gross income from the Virgin Islands, and it is also possible to interpret this 14-percentage-point tax benefit as applying to Virgin Islands corporations.

To prevent the 14-percentage-point tax reduction, your committee's bill amends the Western Hemisphere Trade Corporation provision to require that for a corporation to qualify under this provision, 95 percent or more of its gross income for the past 3 years must be derived from sources without the United States "and the Virgin Islands."

It is the intent of your committee that this provision apply both to a U.S. corporation's tax liability to the United States and the Virgin Islands with respect to gross income derived from the Virgin Islands and with respect to a Virgin Islands corporation's Virgin Islands tax liability with respect to gross income derived from the United States

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(or the Virgin Islands). In neither case is it intended that a 14-point tax reduction be available.

This provision is to be effective with respect to taxable years beginning after the date of enactment of this bill.

In adding this provision to the bill, the committee intends no inferences to be drawn as to what constitutes the appropriate interpretation of existing law in the cases affected by this amendment.

8. Capital gains and stock options (sec. 308 of the bill and sec. 58 (g) (2) of the code)

Under present law, stock options and capital gains which are derived from sources outside the United States are subject to the minimum tax for tax preferences only if the foreign country taxes them at a preferential rate. The suggestion has been made that no preferential treatment exists for this purpose where, for example, a capital gain is realized in a foreign country which imposes no, or only a very small tax on all income (including capital gains).

Your committee believes that it was not the intent of Congress to exclude capital gain (and stock option) income from the minimum tax in situations of this type and that there should be a clarification of the situations in which capital gain (and stock option) income attributable to foreign sources will be subject to the minimum tax. Accordingly, the bill provides that income of these types which is attributable to foreign sources is to be treated as receiving preferential treatment (and, thus, be subject to the minimum tax) if the foreign country imposes no significant amount of tax with respect to those items of income.

The types of situations in which capital gain income is to be treated as receiving preferential treatment under the bill include those where the country involved imposes either no tax or an insignificant tax with respect to capital gains or other income, or both.

The amendment made by this section is to apply to taxable years beginning after December 31, 1969.

9. Certain treaty cases (sec. 309 of the bill and sec. 7422(f) (1) of the code).

In 1966 Congress provided that civil actions for refunds in tax cases could be maintained only against the United States and not against an employee of the United States (e.g., a district director of the Internal Revenue Service). Inadvertently, this may have had the effect of denying persons the right to bring refund suits against the United States in tax cases arising under a tax treaty with another country. This is because under the judicial code (28 U.S.C. 1502) the Court of Claims (and correspondingly the District Courts), which are the forums in which tax refund cases generally are brought, are denied jurisdiction in cases against the United States which arise out of treaties with foreign countries.

It clearly was not the intent of Congress in enacting the 1966 legislation to deny a person the right to bring refund claims against the United States in cases where the claim arises out of a tax treaty. Persons bringing actions arising under a treaty for the refund of a tax should have the same right to bring suit as is available to taxpayers generally. Accordingly, the bill provides that tax refund suits and proceedings may be brought against the United States notwithstanding the provision of the judicial code (28 U.S.C. 1502) which denies jurisdiction to the Court of Claims (and correspondingly to the United States District Courts), in treaty cases generally.

The amendment made by this section is to apply to suits or proceedings which are instituted after January 30, 1967, the effective date of the 1966 legislation.

D. Repeal of the Manufacturers Excise Tax on Passenger Automobiles, Light-Duty Trucks, Etc.

1. Repeal of the excise tax on passenger automobiles, light-duty trucks, etc. (secs. 401 (a) and (f) of the bill and sec. 4061 of the code)

The excise tax on passenger automobiles (imposed on the manufacturer's or importer's sales price) presently is 7 percent. However, present law provides that this is to be phased out over a period of 10 years. The current 7-percent rate continues through 1972. For 1973 there is a one-percentage-point reduction (to 6 percent) and for 1974 there is another one-percentage-point reduction (to 5 percent). In the period 1974 through 1977, the tax rate remains at 5 percent. Thereafter, the tax rate again decreases by one percentage point a year until 1982, at which time the tax is repealed.

The excise tax on trucks and buses, highway tractors, truck and bus trailers, and semitrailers presently is 10 percent. Present law provides that this is to be reduced to 5 percent on October 1, 1977.

As indicated under the discussion with respect to reasons for the bill, the excise tax on passenger automobiles is repealed in this bill both to provide a stimulus for the purchase of cars and because of the jobs this is expected to create. In addition Congress has previously concluded that excise taxes, such as the one on passenger automobiles, are undesirable because they interfere with the freedom of consumer choice. As indicated previously, the tax on light-duty trucks is repealed because, to a substantial degree, these trucks are used by many families in farm areas, as well as by other individuals, as a means of peronal transportation comparable to the use made of passenger cars.

In repealing the excise taxes on passenger automobiles, light-duty trucks, etc., your committee intends that the full amount of the repealed tax be passed on to the consumer, thereby reducing the price of the automobile or the truck. The major automobile manufacturers have pledged to do their best to see to it that the tax reduction is passed on to consumers. To give added assurance that this consumer benefit actually occurs and continues in the case of passenger automobiles and light-duty trucks, your committee requests that the Council of Economic Advisers examine into the matter and report periodically to Congress regarding the extent to which the tax reduction is in fact being passed on.

In view of the considerations set forth above, your committee's bill repeals the 7-percent excise tax on passenger automobiles and also the 10-percent excise tax on light-duty trucks which have a gross vehicle weight of 10,000 pounds or less (as determined under regulations prescribed by the Secretary or his delegate).

Present law (sec. 4061(a)(2)) taxes passenger automobile trailers and semitrailers (i.e., small auto-towed trailers "suitable for use in connection with passenger automobiles") at the same rate of tax as passenger automobiles. The bill also repeals the tax on those articles.[1]

Under present law, buses also are taxed in the same category as trucks (sec. 4061(a)(1)). Thus, the bill also repeals the tax on buses which fall within the 10,000-pound gross vehicle weight limit established for light-duty trucks.[2]

Generally, a truck or other automobile consists of two parts, namely, a body and a chassis. Technically, the tax applies to the sale by the manufacturer of each. In the case of bodies, an exemption is available (secs. 4063(b) and 4222(d)) when a body is sold by the body manufacturer to a manufacturer (but not an importer) of trucks. Thus, where a chassis manufacturer purchases a body tax free, he will pay the tax on his sale of the completed vehicle. Where a body manufacturer purchases a chassis on which a tax has been paid, he is liable for a tax based only on the sale price of the body.

Since truck chassis and truck bodies are frequently sold separately by their respective manufacturers, the light-duty truck exemption applies to a chassis or a body that is suitable for use with a vehicle having gross vehicle weight of 10,000 pounds or less. This means that if a truck chassis manufacturer sells a chassis which is suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less, the chassis will be exempt from the 10-percent excise tax regardless of the body that may actually be mounted on it. However, chassis modifications constituting further manufacture of the chassis at any time before use and subsequent to the manufacturer's sale may result in a tax being imposed on the subsequent manufacturer's sale (or use), if the modified chassis is suitable for use with a vehicle having a gross vehicle weight in excess of 10,000 pounds. A body that may be suitable for use with a vehicle having a gross vehicle weight of 10,000 pounds or less is similarly exempt even though it may also be suitable for use with (and actually be mounted on) a chassis that is suitable for use with a vehicle in excess of this weight limitation. (In this latter case, however, the chassis would be subject to the 10-percent tax.) In general, it is expected that this exemption for light-duty trucks which have a gross vehicle weight of 10,000 pounds or less will exempt half-ton and three-quarter-ton trucks.

The exclusion from the 10-percent truck excise tax for light-duty trucks includes the original equipment on the truck when it is sold. That is, parts and accessories that in the past have been subject to the 10-percent truck tax because of the sale of the truck, in the future are not to be subject to the parts tax. The bill does not, however, affect the application of the 8-percent tax on truck parts and accessories.

The Secretary or his delegate is to prescribe in regulations a standard for determining the gross vehicle weight. This standard will not necessarily be the gross vehicle weight as specified by a manufacturer, a Federal agency providing rules for purposes other than this manufacturers' excise tax, or any State.

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[1] Most of the references in this report to automobiles apply also to these small trailers.
[2] The references in this report to light-duty trucks apply also to any such small buses.

In the case of a sale of an ambulance, hearse, or combination ambulance-hearse, present law (sec. 4062(b)) treats these vehicles as passenger automobiles so that the 7-percent automobile excise tax applies to them. In order to preserve the passenger automobile treatment, the bill exempts these vehicles from the excise tax on trucks.

2. Floor stocks refunds (sec. 401(b) of the bill and sec. 6412 of the code)

Under present law, (sec. 6412(a)(1)), floor stocks refunds would be made available in regard to passenger automobiles on the various tax reduction dates which were to be effective (in the absence of this bill) in the years 1973 through 1982. Floor stocks refunds are also provided in the case of rate reductions on trucks, buses, trailers, etc., scheduled for October 1, 1977.

To avoid creating competitive disadvantages because of the relative sizes of dealers' inventories and in conformity with prior practice, your committee's bill makes provision for floor stocks refunds with respect to passenger cars and light-duty trucks in dealers' inventories on the tax repeal date (the day after the date of the enactment of the bill). This floor stocks refund (or credit) is available with respect to passenger automobiles, light-duty trucks, etc., sold by the manufacturer or importer before the tax repeal date, which are still held by the dealer on that date, and which have not been used but are intended for sale by him. The credit or refund for these floor stocks must be claimed by the manufacturer or importer before the first day of the 10th calendar month beginning after the tax repeal date, based upon reports submitted to him from the dealer before the first day of the 7th calendar month beginning after the tax repeal date. Also, before the first day of the 10th calendar month, the manufacturer or importer must have reimbursed the dealer for the tax or obtained his written consent to the allowance of the refund or credit. In addition, the manufacturer or importer must have in his possession evidence of the inventories on which the credit or refund is claimed (to the extent required by regulations prescribed by the Secretary of the Treasury or his delegate).

A passenger automobile or light-duty truck is not to be treated as having been sold before the tax repeal date (and, generally, is to be treated as being in the dealer's inventory on that date) unless possession or right to possession of the vehicle passes to the purchaser before that date.

In high-volume situations, where it is impossible or highly impractical to determine the exact amount of the tax on a vehicle-by-vehicle basis, it is contemplated that manufacturers will be able to comply with the floor stocks refund requirements on an average basis. For example, since manufacturers' transportation expenses are excludable from the rate base upon which the passenger automobile tax now is imposed (sec. 4216(a)), it is expected that manufacturers will be permitted to compute the credit for any one class of passenger cars (automobiles of the same model, which are sold by the manufacturer with the same equipment and accessories) by reducing the actual sale price by the average transportation costs for that class of passenger cars. Such procedures were used in connection with the Excise Tax Reduction Act of 1965.

It is expected that these floor stocks refund claims will be processed promptly. It is anticipated that the Internal Revenue Service will make refunds within 45 days of the receipt of the claims. There is no intention to have the Government unreasonably retain these excess taxes or to have the manufacturers be out-of-pocket the amounts of these taxes for an extended period of time. Indeed, any such unnecessary delays would tend to detract from the stimulative purposes of these provisions.

3. Refunds with respect to certain consumer purchases (sec. 401(c) of the bill)

In connection with the repeal of the excise tax on passenger automobiles, your committee's bill also makes provision for refunds of the excise tax to consumers with respect to their purchases after August 15, 1971, and before the day after the date of enactment of this bill (when the tax is actually eliminated). In addition, your committee has provided for consumer refunds in the case of the excise tax on light-duty trucks and buses purchased by consumers after September 22, 1971, and before the day after the date of enactment of this bill. Provision for these refunds is necessary to forestall the postponement of purchases of the cars and light-duty trucks until the date of the repeal of the tax. This provision is consistent with Congress' actions in 1965 with regard to passenger automobiles and air conditioners—articles where it was thought delays in purchases might adversely affect total sales.

The bill provides that the government is to refund (or credit) to the manufacturer (or importer) of the tax-repealed automobile, truck, etc., the tax he paid on his sale of the article. However, to obtain this refund (or credit) the manufacturer (or importer) must file his claim with the Internal Revenue Service before the beginning of the 10th calendar month beginning after the day the tax is repealed. This claim is to be based on information submitted to him by the dealer (or other person) who sold the article to the ultimate purchaser. This information must be submitted to the manufacturer before the first day of the 7th month after the date of repeal. Also, before the beginning of the 10th calendar month after the date of repeal, the "ultimate purchaser" must be reimbursed for the tax paid on the article he purchased.

The "ultimate purchaser" is the consumer or user of the new article. This includes a dealer in the case of a driver-training car where he retains ownership, a demonstrator (unless sold as a new car, in which case see the discussion below) or any other car owned by him and used in his business, and a lessor with respect to a leased car.

A passenger automobile is not to be treated as having been sold before August 16, 1971 (or light-duty truck before September 23, 1971) unless possession or right to possession of the vehicle has passed to the purchaser before that date.

It is expected that a consumer who purchases a passenger automobile or light-duty truck during the post-August 15 or post-September 22 period will be informed (or has already been informed) that, if these excise taxes are repealed, he will be refunded the amount of the tax. In these cases the dealer is to notify the manufacturer as to the persons to whom he sold specific automobiles, trucks, etc. during the refund period. This notification must reach the manufacturer before the beginning of the 7th calendar month after the repeal of the tax. This gives the manufacturer time to process the claims, make reimbursements, and file his overall claim (or claims) with the Internal Revenue Service before the beginning of the 10th calendar month after the date of repeal of the tax. The reimbursement may be made directly by the manufacturer to the consumer or may be made through the dealer who originally sold the article.

As with floor stocks refunds, in high-volume situations where it is impossible or highly impractical to determine the exact amount of the tax on a vehicle-by-vehicle basis, it is contemplated that manufacturers will be able to comply with the consumer refund requirements using a limited amount of averaging. For example, since manufacturers' transportation expenses are excludable from the rate base upon which the passenger automobile tax now is imposed, it is expected that manufacturers will be permitted to compute the credit for any one class of passenger cars by reducing the actual sale price by the average transportation costs for that class of passenger cars. This method is not to be permitted unless the manufacturer demonstrates that the refunds to consumers are not less than the aggregate of the taxes that had previously been passed on to the consumers on account of consumer purchases during the relevant period (i.e., after August 15 or September 22). Apart from the averaging device just described, and similar adjustments where this is found necessary, the entire tax that had been passed on to a consumer must be refunded to the consumer for the manufacturer to obtain any refund under this provision. Such procedures are the same as those used after the Excise Tax Reduction Act of 1965.

Your committee intends and expects the Internal Revenue Service to allocate the necessary personnel to process consumer refund claims as soon as possible. The manufacturer is not to be permitted to claim a refund until he shows he has already reimbursed the ultimate purchaser. However, there is no intention that the government delay refunding taxes or that the manufacturers be out-of-pocket for the taxes any longer than is necessary for administrative reasons. Indeed, any unnecessary delays would detract from the stimulative purposes of these repeal provisions.

4. "Demonstrator" vehicles

The floor stocks refunds and consumer refunds provided by this bill are to be available only in the case of "new" tax-repealed articles sold during the periods described above or held by a dealer at the time the repeal of the taxes becomes effective. Questions have arisen as to whether "demonstrators" are new for this purpose. "Demonstrators" are passenger automobiles and light-duty trucks used by a dealer's sales personnel for a period of time and then sold.

Your committee believes that "demonstrators" should be treated as "new," and thus entitled to the consumer or floor stocks refunds, where they are intended for sale as new vehicles rather than as used ones. In the case of passenger automobiles, a demonstrator may be considered sold as new, (or in the dealer's inventory on the tax repeal date) if the dealer shows that the label required by the Automobile Information Disclosure Act of 1958 (Public Law 85–506) was affixed to a window of the vehicle when the vehicle was sold (or was in the dealer's inventory on the tax repeal date). In addition, the dealer must show either that the vehicle was sold (or was to be sold) under a full written or express warranty by which the manufacturer is obligated to the consumer, or must show "newness" by other evidence acceptable to the Internal Revenue Service. It is anticipated that the Internal Revenue Service will provide that a written or express warranty will not be considered to be a full warranty unless more than 80 percent of the mileage and time-period coverage is unexpired on the date the vehicle is sold (or is held for sale in the dealer's inventory on the tax repeal date). However, a resale of a vehicle will never be considered to be the sale of a new vehicle even if more than 80 percent of the mileage and time period coverage is unexpired on the date the vehicle is sold (or is held for sale in the dealer's inventory on the tax repeal date).

Where after August 15 and before the day after the date of enactment of the bill a dealer purchases a passenger automobile from a manufacturer and the automobile is used by the dealer as a demonstrator, but not in a manner which qualifies it as a new automobile, the dealer would be considered the ultimate purchaser and therefore eligible for a consumer refund. This would be true even if the dealer sold the car to a consumer as a used car prior to the day after the date of enactment. (For administrative purposes, however, the Internal Revenue Service may decide to permit the dealer to elect (with the consent of the manufacturer) to include such an automobile in his floor stocks inventory (whether or not held by the dealer on the day after the date of enactment) as an alternative to requesting separate reimbursement under the consumer refund provisions of the bill.)

In the case of light-duty trucks used by the dealer as "demonstrators", there is no statutory requirement that the truck display any label. As a result, although generally the same circumstances described above for automobiles used as demonstrators apply in the case of light-duty trucks used as demonstrators, there is to be no requirement that a label be displayed.

5. Certain uses by manufacturer, etc. (sec. 401(d) of the bill and sec. 4218 of the code)

Under present law, if a manufacturer (or importer) of a passenger automobile or a light-duty truck, uses the vehicle himself (other than in the manufacture of another taxable article), he is liable for tax in the same manner as if the article were sold by him. In this case the tax is computed on the price at which he (or other manufacturers or importers) sells the same or similar articles in the ordinary course of trade.

Your committee believes that where a manufacturer (or importer) pays a tax on account of his use of the article during the consumer refund period, he is as much entitled to reimbursement as would be any other consumer. Accordingly, your committee's bill provides that where an automobile or light-duty truck is used by a manufacturer (or importer) and as a result of this use a tax was paid after August 15, 1971, in the case of automobiles (or September 22, 1971, in the case of light-duty trucks) the payment is to be treated as an overpayment.

The effect of this is to entitle the manufacturer (or importer) to a refund (or credit). In such a case, of course, the subsequent sale of the vehicle would not also give rise to a consumer refund or a floor stocks refund.

6. Other technical changes

Small three-wheeled motor vehicles (sec. 401(f) of the bill and sec. 4063 of the code).—Under present law the excise tax on trucks does not apply to a small three-wheeled vehicle whose chassis weighs not more than 1,000 pounds and which is powered by a motor which does not exceed 18 brake horsepower (rated at 4,000 revolutions per minute). Since the bill repeals the tax on light-duty trucks which have a gross vehicle weight of 10,000 pounds or less, your committee concluded that there is no need to continue this exemption since these vehicles would in any event be free of tax under the exemption for light-duty trucks. Accordingly, the bill repeals the exemption for these small three-wheeled vehicles.

Rate of tax stated on new car labels (sec 401(f) of the bill).—The Excise, Estate, and Gift Tax Adjustment Act of 1970 (sec. 304 of that Act, 15 U.S.C. 1232(a)) provided that where a manufacturers' excise tax is imposed under the Internal Revenue Code on a sale of a new automobile, which is required by the Automobile Information Disclosure Act to have a label affixed to it, the person required to affix the label must also state on the label that the Federal manufacturers' excise tax was imposed and the percentage rate at which the tax was imposed. Since your committee's bill repeals the excise tax on automobiles, there is no reason to continue this provision. Accordingly, the bill repeals the 1970 Act's label information requirement, effective after the date of the enactment of the bill.

Installment sales, etc. (sec. 401(g) of the bill and sec. 4216(c) of the code).—In the case of partial payments in connection with leases, certain types of installment sales, conditional sales, or certain types of chattel mortgage arrangements, present law provides that the manufacturers' excise tax is to be paid upon each partial payment and is to be based on the tax rate in effect on the date each partial payment is due. To avoid windfall benefits to a manufacturer where the lease, installment sale, etc., took into account the 7-percent or 10-percent tax, the bill provides that no tax is due on partial payments after the tax repeal date if the lessor or vendor establishes that the amount of the payments payable after that date has been reduced by the amount of tax that would otherwise have been due with each partial payment after that date. If the lessor or seller does not reduce the amount of the payments, however, the tax reduction provided by the bill will not apply to the article on which those partial payments are being made. In other words, for the tax reduction to be available in partial payment cases, the benefit of the repeal must be passed on to the lessee or purchaser.

7. Effective date (sec. 401(g) of the bill)

The repeal of the excise tax on passenger automobiles, light-duty trucks, etc., applies to articles sold on or after the day after the date of the enactment of the bill.

The bill also provides that an article is not to be considered as sold before the day after the date of the enactment of the Act unless possession or right to possession passes to the purchaser before that day.

8. Revenue effect

The revenue loss from the repeal of the excise tax on passenger automobiles is estimated to be $2.2 billion for the fiscal year 1972, $2.0 billion for the fiscal year 1973, and $1.8 billion for the fiscal year 1974. This decline in revenue loss is due to the scheduled decrease in the tax rate under present law from 7 percent for 1972 to 6 percent for 1973, and to 5 percent for 1974. The long-run revenue loss from the immediate repeal by the bill will be further reduced by the scheduled phaseout under present law of the tax and its eventual repeal as of January 1, 1982.

It is estimated the repeal of the excise tax on light-duty trucks and buses will result in a revenue loss of $280 million for the fiscal year 1972 and $360 million for the fiscal year 1973. This revenue loss will come out of the Highway Trust Fund. For the fiscal year 1973, estimated receipts from the tax on light-duty trucks under present law would represent about 50 percent of the projected $720 million in revenues under present law from the tax on all trucks and buses and approximately 6 percent of the total Trust Fund revenues of $5.9 billion.

E. Domestic International Sales Corporations

As indicated in the discussion of the reasons for the bill, your committee believes that it is important to provide tax incentives for U.S. firms to increase their exports. This is important not only because of its stimulative effect but also to remove a present disadvantage of U.S. companies engaged in export activities through domestic corporations. Presently, they are treated less favorably than those which manufacture abroad through the use of foreign subsidiary corporations. United States corporations engaging in export activities are taxed currently on their foreign earnings at the full U.S. corporate income tax rate regardless of whether these earnings are kept abroad or repatriated. In contrast, U.S. corporations which produce and sell abroad through foreign subsidaries generally can postpone payment of U.S. tax on these foreign earnings so long as they are kept abroad.

In addition, other major trading nations encourage foreign trade by domestic producers in one form or another. Where value added taxes or multistage sales taxes are used to any appreciable extent, the practice is to refund taxes paid by the exporter at the time of export and to impose these taxes on importers. In the case of income taxes as well, however, most of the major trading nations have features in their tax laws which tend to encourage exports. Both to provide an inducement for increasing exports and as a means of removing discrimination against those who export through U.S. corporations, your committee's bill provides a deferral of tax where corporations meeting certain conditions—called Domestic International Sales Corporations—are used.

1. An overall view

For the reasons discussed above, your committee's bill provides a system of tax deferral for a new type of U.S. corporation known as a Domestic International Sales Corporation, or a "DISC," and its shareholders. Under this tax system, the profits of a DISC are not to be taxed to the DISC but instead are to be taxed to the shareholders when distributed to them. This tax deferral treatment is limited, however, to the extent of the increase in the exports of the parent and affiliated companies over 75 percent of the level of their exports in the years 1968 through 1970.

The deferral of tax accorded to profits earned by the DISC ends not only when those profits are distributed to the DISC's shareholders but also when the DISC fails to continue qualifying as a DISC (in this case the profits are taxed to the shareholders as "deemed" distributions). For example, when a DISC's profits are distributed to a corporate shareholder, the shareholder is treated in most respects as if it were the initial recipient of the profits; as a result, no intercorporate dividends received deduction is available for these profits, but instead the profits are to be treated as foreign source income and the shareholder is to be allowed to credit against its tax liability on these profits any income taxes paid to a foreign country (by the DISC if the taxpayer is on the "per country" limitation or by the DISC or on income of the shareholder from other foreign sources—but this income cannot be used to offset unrelated foreign tax credits—if it is on the "overall limitation").

To qualify as a DISC, at least 95 percent of a corporation's gross receipts must arise from export sale or lease transactions and other export-related investments or activities. In addition, at least 95 percent of the corporation's assets must be export related. Included in export-related assets are "producer's loans" which are loans (subject to certain restrictions) made to the U.S. parent producer (or any other U.S. exporter) to the extent of the producer's assets used for export business. These loans by a DISC do not give rise to taxation of the DISC or the parent on the amounts loaned.

Although up to 25 percent of the base period income plus any increase in the income of a DISC is not to be subject to current taxation, each year a DISC is to be deemed to have distributed to its shareholders certain types of its income, thus, subjecting that income to current taxation in the shareholders' hands. The principal types of income falling in this category are the income representing 75 percent of the base period income plus the interest realized by the DISC on its "producer's loans."

Generally, present law requires sales between a parent corporation and its subsidiary to be made on an arm's length basis; that is, at the price the parent company would have charged an unrelated third party. Special pricing rules in the bill permit a DISC to earn a larger relative amount of the profits arising on sales by the DISC of its parent company's export products.

2. Taxation of a DISC (sec. 501 of the bill and sec. 991 of the code)

As a general rule, the bill provides that a DISC is not to be subject to income taxes (or more specifically the taxes imposed by subtitle A) although the shareholders are taxed on an amount representing up to

75 percent of the DISC's base period income. The profits of a DISC are to be fully free of tax in the hands of the DISC (as discussed subsequently, these profits will be subject to tax in the hands of the shareholders when distributed or deemed distributed). Both the determination of whether a corporation qualifies as a DISC and the tax deferral provided by the bill apply on a year-by-year basis. The taxes foregone in the case of a DISC include not only the regular corporate income tax, but also the minimum tax on tax preferences, and the accumulated earnings tax. Since a personal holding company cannot qualify as a DISC, the bill does not relieve a corporation from this tax (sec. 541 of the code).

3. Requirements of a DISC (sec. 501 of the bill and sec. 992 of the code)

Definition of "DISC" and "former DISC".—The bill provides that a corporation will qualify as a DISC for a taxable year if four requirements are satisfied with respect to the taxable year: the gross receipts test, the assets test, the capitalization requirement, and the election requirement. A DISC, also, must be an incorporated entity (under the laws of any State or the District of Columbia) and, thus, associations otherwise treated as corporations under the code may not qualify as a DISC.

First, at least 95 percent of a corporation's gross receipts (defined in sec. 993 (f)), for the taxable year must be composed of qualified export receipts. As discussed subsequently, qualified export receipts include receipts arising on the sale or lease of export products as well as receipts from other specified export-related activities. In addition, where a corporation seeking to qualify as a DISC sells products of a U.S. manufacturer on a commission basis (rather than on a purchase and resale basis), the amount of gross receipts arising on the commission sale is to be the gross receipts from the sale of the property which gave rise to the commission.

Second, at least 95 percent of the assets of a corporation at the close of its taxable year must be qualified export assets (determined with reference to the adjusted basis of the assets).

Third, to qualify as a DISC, a corporation must have at least $2,500 of capital (on each day of the taxable year as measured by the par or stated value of its outstanding stock). This test is designed to make sure that a corporation may qualify as a DISC even though it has relatively little capital. It is recognized that this rule constitutes a relaxation of the general rules of corporate substance. The separate incorporation of a DISC is required to make it possible to keep a better record of the export profits to which tax deferral is granted, but this does not necessitate in all other respects the separate relationships which otherwise would exist between a parent corporation and its subsidiary. This, however, is not intended to lessen the general rules of corporate substance required for other corporations in other contexts.

The capitalization requirement also precludes a DISC from having more than one class of stock. This requirement is included in view of the complexity which would result under a deferral system of taxation if the corporation were allowed to have more than one class of stock. For example, if more than one class of stock were allowed where the DISC's earnings must be deemed paid to its shareholders, it would be necessary to include in the bill a special set of rules specifying how the earnings would be allocated to each class of stock.

Fourth, to qualify as a DISC for any year, a corporation must have elected to be treated as a DISC.

The rules provided by the bill are to apply to a corporation and its shareholders for any year in which it is a DISC and for any year in which, although it is not a DISC for that year, there are potential tax consequences arising from the fact that it was a DISC for a prior year. In the latter case the corporation is considered a "former DISC." There are two potential tax consequences resulting from the fact that the corporation was a DISC in a preceding taxable year: the corporation may have undistributed amounts of tax deferred income which are to be taxed to its shareholders or it may have undistributed amounts of income which previously had been taxed to the shareholders but not actually distributed to them.

In addition, provision is made for regulations to provide rules dealing with a corporation which has filed a return as a DISC and subsequently claims that it is not eligible for DISC status. The regulations would provide that in the case of a corporation which has not indicated more than 30 days before the running of the statute of limitations for the year that it is not a DISC and has filed a tax return as if it were a DISC, then the corporation (and its shareholders with respect to distributions or deemed distributions from the corporation) is to be treated as if it were a DISC for the year in question, if the Internal Revenue Service has not issued a notice of deficiency based upon a determination that the corporation was not a DISC.

Election to be treated as a DISC.—For a corporation to qualify as a DISC under the election referred to above, it must (except as otherwise provided in rules prescribed by the Treasury) make the election during the 90-day period immediately prior to the beginning of the taxable year. In addition, for the election to be valid, all of the persons who are shareholders on the first day of the initial election year must consent to the election. The requirement that the shareholders consent to the election need not be satisfied on the first day of the first taxable year for which the election is effective. It is anticipated the corporation will be given a reasonable period of time to obtain these consents. However, if it fails to obtain all of these consents within the time specified, except where the statute has run and it has not been determined that the corporation was not a DISC (sec. 992 (a)(2)) the corporation will not be treated as a DISC.

Once made, an election continues in effect for subsequent years whether or not the corporation actually qualifies as a DISC in a given subsequent year, until such time as the election is either revoked or is terminated by reason of a continued failure over a 5-year period of the corporation to qualify as a DISC. The purpose of this provision is to make it unnecessary for a corporation to make a new election each year to qualify as a DISC. If a corporation makes a valid election to be treated as a DISC, the rules provided by the bill apply to the corporation and to all persons who are shareholders of the corporation at any time on and after the election becomes effective (i.e., not only the initial shareholders but their successors in interest as well).

An election to be treated as a DISC may be revoked at any time after the first year it is in effect. For a revocation to be effective for a given year, however, it must be made within the first 90 days of that year. A revocation made after the expiration of the 90-day period will not take effect until the following year. The bill also provides for the automatic termination of an election where the corporation does not qualify as a DISC for a period of five consecutive taxable years.

An election to be a DISC has continuing effect except where it is discontinued or where the corporation fails to qualify for a five-year period, in order to prevent the termination of the election inadvertently through unintentional disqualification in one or more years. However, even where a DISC election has been terminated voluntarily or under the five-year rule, the corporation would be permitted to make a new election in the future to be treated as a DISC if it so desires.

Distribution to meet qualification requirements.—The bill provides for situations under which a corporation may distribute its nonqualified receipts or assets after the end of the taxable year, in order to satisfy the 95-percent gross receipts and 95-percent assets tests for a year. The purpose of this is to prevent a corporation from failing to qualify for DISC treatment in a year merely because of its inadvertent failure to meet the gross receipts or assets test.

The amount a corporation must distribute under the distribution rules set out below is the sum of (A) the portion of its taxable income attributable to its nonqualified gross receipts (if it fails to satisfy the gross receipts test) plus (B) the fair market value of the nonqualified export assets held by it on the last day of the taxable year (if it fails to satisfy the assets test for the year). In either case the entire nonqualified amount must be distributed and not merely an amount equal to the extent to which the corporation failed to satisfy the test or tests in question. In determining the portion of a corporation's taxable income attributable to nonqualified gross receipts, the entire amount of the gross income from nonqualified receipts to which expenses are not definitely allocable, such as dividends, will be taken into account. On the other hand, where expenses are properly allocable to income, the expenses are to be considered as reducing the nonqualified gross income.

Also, under both rules a distribution will not cause a corporation to qualify as a DISC unless it is a pro rata distribution to the shareholders with respect to their stock and is specifically designated when made as a distribution to meet qualification requirements. In other words, a corporation which made a normal dividend distribution and which subsequently discovered that it did not qualify as a DISC for the preceding year is not to be permitted to redesignate the initial dividend distribution as a distribution to enable the corporation to qualify as a DISC.

As subsequently discussed, distributions to meet qualification requirements will be fully taxable to the shareholders of the corporation. The dividends received deduction is not to be available with respect to these distributions and, in addition, the distributions are to be treated as U.S. source income (since they are not attributable to qualified export receipts) and thus will not have foreign tax credit consequences.

One distribution rule is designed to apply in those cases where a corporation comes relatively close to satisfying the gross receipts or assets test. A corporation which has failed to satisfy either the gross receipts or assets test is deemed to have acted with reasonable cause with respect to both the failure to meet those tests and the failure to make the distribution prior to the time the distribution is made if at least 70 percent of the corporation's gross receipts for the year are qualified export receipts and at least 70 percent of the assets held by the corporation on the last day of each month of the year are qualified export assets, and if it makes a distribution of the appropriate amount within 8½ months after the close of the taxable year. For this purpose all assets are taken into account at their adjusted basis. Where these conditions are satisfied, a corporation will be treated as having satisfied the gross receipts and assets test for the taxable year.

A second distribution rule is designed to deal with the situation where there is both reasonable cause for a corporation's failure to meet the gross receipts or assets test and reasonable cause for its failure to make the distribution earlier than when it was made. Where there is a reasonable cause, the required distribution may be made whether or not less than 70 percent of the corporation's gross receipts or assets were qualified.

In addition, in this situation, the corporation is not required to make the distribution within the 8½ months after the end of the year, as required by the first distribution rule, if the failure to make the distribution to meet the gross receipts or assets test within 8½ months and before the date when actually made is due to reasonable cause. Examples of conditions that may be reasonable cause are blocked foreign currency and foreign expropriation. If conditions exist which constitute reasonable cause but subsequently no longer exist, it is understood the regulations will provide that a corporation will no longer have reasonable cause for failure to make a distribution after the 90th day after the conditions constituting reasonable cause no longer exist.

Generally, the reasonable cause requirement is to be considered as being satisfied where the action or inaction which resulted in the failure to meet the gross receipts or assets test (or failure to make the distribution earlier than when it was made) occurred in good faith. For example, if the corporation's qualified receipts subsequently were determined to be less than 95 percent of its total receipts as a result of a price adjustment made by the Internal Revenue Service (under sec. 482), or if the corporation received an unanticipated insurance recovery which caused its qualified receipts to be less than 95 percent of total receipts, the failure to satisfy the gross receipts test is to be considered due to reasonable cause.

It is understood that the regulations will provide that where the reasonable cause test is satisfied, a corporation may qualify as a DISC under this second rule, subject to two conditions. First, if the taxpayer believes in good faith that he had satisfied the gross receipts or assets test, the appropriate distribution generally must be made within 90 days from the time the Internal Revenue Service notifies the corporation it has not satisfied the gross receipts or gross assets test. This period may be extended by the Service if the Commissioner determines additional time is reasonable and necessary to permit the distribution to be made. In addition, the period for making the distribution is to be extended in any case where the corporation contests the determination of the Service in the Tax Court.

The second requirement which must be met under this second distribution rule is that the corporation must pay a charge to the Service. This charge is intended to reflect the fact that the tax owing on the distribution (from the shareholder), in effect, has been deferred from the year in which the distribution should have been made until the year in which it actually is made. The amount of the charge is 4½ percent of the distribution times the number of taxable years that the distribution is delayed. (Since the charge is imposed on the entire amount of the distribution this is the equivalent of a 9-percent rate if the distributions were taxable at 50 percent.) For this purpose, the year with respect to which the distribution is made is not taken into account but the year in which it is made is taken into account. This charge is to be treated by the corporation as an interest payment. The payment must be made within 30 days of the time the distribution is made.

Ineligible corporations.—The bill excludes from DISC treatment various types of organizations where it would be inappropriate to combine the present treatment of the organization with DISC treatment. These ineligible organizations are tax-exempt organizations, personal holding companies, banks, savings and loan associations and other similar financial institutions, insurance companies, mutual funds, China Trade Act corporations and subchapter S corporations.

4. Definitions and special rules (sec. 501 of the bill and sec. 993 of the code)

Qualified export receipts.—As previously discussed, for a corporation to qualify as a DISC 95 percent of its gross receipts must consist of receipts which are considered to be export related—i.e., qualified export receipts. The bill specifies that the following are qualified export receipts—

(1) Receipts from the sale of export property (as discussed subsequently, this generally means property such as inventory manufactured or produced in the United States which is sold for direct use, consumption or disposition outside the United States or to an unrelated DISC for such a purpose. Thus, a sale of property to an American manufacturer for incorporation in a product to be exported would not be considered for this purpose as an export sale.)

(2) Receipts from the leasing (including subleasing) or rental of export property for use by the lessee outside of the United States. (Whether leased property satisfies the usage test is to be determined on a year-by-year basis. Thus, the receipts on a lease of export property might qualify in some years and not in other years depending on the lessee's usage of the property in the years involved.) However, a *de minimis* use of the property in the United States is permissible.

(3) Receipts from services rendered in connection with a qualified export sale, lease or rental transaction if the services are related and subsidiary to the basic export transaction. In general, a service is related to a sale, lease or rental if it is of the type customarily and usually furnished with that type of transaction in the trade or business in which the transaction arose and the contract to furnish these services is connected with the sale,

lease or rental. A service is subsidiary if it is of less importance and value as compared to the sale or lease. (Transportation services or services related to the installation or maintenance of export property would generally qualify as related and subsidiary to the sale, etc.) [1]

(4) Gains from the sale of qualified export assets (i.e., plant and equipment used in the corporation's export business but not inventory).

(5) Dividends (and amounts considered as distributed under subpart F) from a related foreign export corporation (generally a foreign selling subsidiary of the corporation seeking to qualify as a DISC).

(6) Interest on obligations which are qualified export assets, such as accounts receivable arising in connection with qualified export sale, lease or rental transactions, producer's loans, and obligations issued, guaranteed, or insured by the Export-Import Bank.

(7) Receipts from engineering or architectural services on foreign construction projects which either are located abroad or proposed for location abroad. These services would include feasibility studies, and design, engineering and construction supervision. They would not include the provision of technical assistance or know-how or services connected with the exploration for oil.[2]

(8) Receipts for management services provided for other DISC's (in most cases a series of small DISC's) to aid those DISC's in deriving qualified export receipts. (These would include the various managerial, staffing, and operational services necessary to operate a DISC.)

To limit the application of the deferred tax treatment provided by the bill to situations which, in fact, involve export transactions, the bill provides that regulations may designate certain receipts as nonqualified export receipts. Receipts from five types of transactions, not really export transactions, will be excluded from the category of qualified export receipts. These include, first, receipts arising from the sale or rental of property for ultimate use in the United States. Generally, property is to be considered sold or rented for ultimate use in the United States either if it is sold (or otherwise transferred) to a related person who uses or resells the property (whether or not incorporated into other property) in the United States or, in the case of a sale to an unrelated person, if the sale is pursuant to an agreement or understanding that the property will be used in (or resold for use in) the United States or if a reasonable person would have known

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[1] For example, if a corporation sells a business machine which is export property and contracts to service the machine, the gross receipts from the services are qualified export receipts. However, if a corporation is engaged to render services and as an incidental part of the services sells export property, the gross receipts from the services are not qualified export receipts since such services are not subsidiary although they are related to such sale.

[2] Examples of services that qualify under this provision are architectural services in connection with the design of a building or civil engineering services in connection with the erection of a public project such as a bridge. The receipts derived from these services are qualified export receipts whether or not they are related and subsidiary to the sale of export property. If an engineering firm is engaged in a turn-key project or sole responsibility project performed abroad, the gross receipts derived from the engineering and architectural services are qualified export receipts. If the engineering firm also sells export property for installation in the project, the sale also produces qualified export receipts. However, the sale of foreign made goods does not generate qualified export receipts.

that the property would be used in (or resold for use in) the United States. For example, if property were sold to a foreign wholesaler and it was known in trade circles that the wholesaler, to a substantial extent, supplied the U.S. retail market, the sale would not be a qualified export sale.

A second category of excluded receipts are receipts from the sale of agricultural products under the P.L. 480 program and other United States Government subsidy programs. A third category is receipts from direct or indirect sales, rentals, or services to the United States Government where the Government is required by law, regulation, or similar rule to purchase U.S. property or services. An example of an indirect sale to the United States Government resulting in a nonqualified receipt would be a sale of products to a foreign wholesaler who it is known in turn resells the products to the United States Army in the foreign country.

A fourth type of receipts which does not qualify are receipts from another member of the same controlled group of corporations as the recipient corporation where the corporation involved is itself a DISC. A final category of nonqualified receipts is receipts arising from services provided in connection with any sale, lease or rental which itself is excluded in any of the above described categories.

Qualified export assets.—As previously indicated, 95 percent of a corporation's assets must be export related if the corporation wishes to qualify as a DISC. The types of assets classified as qualified export assets are—

(1) export property (i.e., inventory meeting certain tests described below);

(2) assets used primarily in connection with the sale, rental, storage, handling, transportation, packaging, assembly or servicing of export property or the performance of managerial, engineering or architectural services producing qualified export receipts;

(3) accounts receivable and evidences of indebtedness of the corporation (or if the corporation acts as agent, the principal) held by the corporation which arose in connection with qualified export sale, lease or rental transactions (including related and subsidiary services) or the performance of managerial, engineering, or architectural services producing qualified export receipts, by the corporation;

(4) money and temporary investments, such as bank deposits reasonably needed for the working capital requirements of the corporation;

(5) obligations arising in connection with producer's loans (as defined below, generally loans of the DISC's profits to its parent company or other U.S. export manufacturer);

(6) stock or securities of a related foreign export corporation;

(7) obligations issued, guaranteed or insured (including reinsurance) by the Export-Import Bank or the Foreign Credit Insurance Association (such as, interest participation certificates and certificates of beneficial ownership) if the obligations are acquired from the Bank or Association or from the person selling or purchasing the goods or services giving rise to the obligations;

(8) obligations of a domestic corporation organized solely to finance sales of export property under an agreement with the Export-Import Bank, where the loans are guaranteed by that bank; and

(9) amounts deposited in banks at the end of its taxable year but which are in excess of the reasonable working capital needs of the corporation which are invested in qualified export assets within a specified period of time after the end of the taxable year.

Where a DISC performs packaging or assembly operations in connection with the export property which it sells, the facilities used for this purpose are to constitute qualified export assets if the operations represent packaging or assembly operations but not if they constitute manufacturing. Generally, if the property sold by the DISC is substantially transformed by it prior to sale, the property is to be treated as having been manufactured by the DISC. In addition, a DISC generally is to be considered as having manufactured property which it sells, if the operations performed by the DISC in connection with that property are substantial in nature and are generally considered to constitute the manufacture, production, or construction of property. Operations performed by a DISC will be considered to be manufacturing if the value added to the product sold by reason of the operations of the DISC accounts for 20 percent or more of the total cost of goods sold.

As indicated above, bank deposits of a DISC which are in excess of its working capital needs are to be considered as qualified export assets if the funds are invested in other qualified export assets within a specified period of time. This provision is designed to allow a DISC some flexibility in its operations, for example, in the case where it receives a repayment of a producer's loan or a substantial income item in the latter part of its taxable year and does not have sufficient time in which to convert the amount into a qualified export asset prior to the end of the year. In such a case it is expected the regulations will provide that the excess cash on hand at the end of the taxable year in the form of bank or similar deposits is to be considered a qualified export asset as of that time, if the following test is met: By the last day of the sixth, seventh, and eighth months after the end of the year, the DISC has increased the amount of its other types of qualified export assets to a level which is at least 95 percent of the amount of the total assets it held on the last day of that year. In other words, it is not required that there be a tracing of the excess bank deposits into specific qualified export assets. Rather, if by the last days of the three months mentioned, the level of the DISC's other types of qualified assets has increased to the point where the DISC would have satisfied the 95 percent assets test, if it had held those assets on the last day of the taxable year in question, then the excess bank deposits are to be considered as qualified export assets on the last day of the year in question.

Export property.—Generally the principal function of a DISC will be the selling, leasing or renting of export property for use outside the United States. The type of property which is considered export property is property which—

(1) has been manufactured, produced, grown or extracted in the United States by someone other than a DISC;

(2) is held primarily for sale, lease, or rental in the ordinary course of business for use, consumption or disposition outside the United States, or which is held by the DISC for sale, lease or rental to another DISC for such a purpose; and

(3) not more than 50 percent of the fair market value of which is attributable to imported articles.

As discussed previously, a DISC may perform assembly operations in connection with the products which it sells. It may not, however, engage in manufacturing or construction activities with respect to those products. If the activities performed by a DISC in connection with the products represent the manufacture of property, then the products will not be considered export property and the gross receipts from the sale of the products will not be qualified receipts.

In determining whether property which is sold to another DISC is sold for direct use, consumption or disposition outside the United States, the fact that the purchasing DISC holds the property in inventory prior to the time it sells it for use, etc., outside the United States will not affect the characterization of the property as export property.

In determining whether a product has a sufficient amount of U.S. components so as to be eligible for classification as export property, any foreign components imported into the United States and incorporated in the product are to be taken into account at their fair market value upon importation (i.e., at what would be their full dutiable value in the absence of any special provisions in the tariff laws which result in a lower dutiable value). For example, the fact that imported foreign goods contain some U.S. components, which reduces the value upon which duty is assessed upon importation, is not to be taken into account in determining the amount of the value which the imported property contributes to the property which is to be exported. In other words, in these cases, even though the imported article has some U.S. content, it is to be treated as if it were 100-percent foreign content.

It is contemplated that the customs invoice on the importation of goods into the United States would be used in evidencing the value of the imported goods for purposes of this test. When a U.S. manufacturer sold goods with foreign components to a DISC, it would furnish a certificate to the DISC regarding the amount of the foreign content in the product which would be based on the information on the customs invoice forms.

Although the foreign content test generally is to be applied on an article-by-article basis, it would be permissible to apply the test on a mass account basis where the goods taken into account for this purpose are essentially identical.[3]

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[3] Where identical components of domestic and foreign source are used interchangeably, the limitation on foreign content is to be applied on a substitution basis as in the case of the rules relating to drawback accounts under the customs laws. For example, assume that a manufacturer produces a total of 20,000 electronic devices, 10,000 of which are exported. Assume also that the major single component in each device is a tube which represents 60 percent of the value of the device. Assume further that the manufacturer imports 10,000 of these tubes and the remaining 10,000 were manufactured in the United States. In accordance with the substitution principle used in the customs drawback laws, each of the 10,000 exported devices is considered as containing a tube of foreign origin equal to 60 percent of its total value. As a result, since the 50 percent U.S. content requirement is not met, the exported goods are not export property.

Where a category of property is not in sufficient supply to meet the demands of the domestic economy, even though it would be considered export property under the requirements discussed above, your committee believes it would be inappropriate to make the tax deferral provided by the bill available. In such cases there is no reason to encourage exports. In view of this, the bill provides the President with authority to exclude from the category of export property any property which he determines is not in sufficient supply to meet the requirements of the domestic economy. If the President makes a determination of this nature by the issuance of an Executive Order, the property involved will not be treated as export property during the period for which the President determines and designates it to be in short supply.

The bill also contains a provision designed to prevent U.S. corporations from using a DISC to convert substantial amounts of what otherwise would be manufacturing or operational, as distinct from selling, income into tax deferred income. This could occur if property, which otherwise would be used outside of the United States in the parent's operations, were sold by the parent to a DISC subsidiary and then rented back from the DISC, since this would permit taxable operational profits to be converted into tax-deferred rental income. To prevent this result, the bill provides that any property leased to a corporation which is a member of the same group of controlled corporations as the DISC is not to be considered export property in the hands of the DISC. For this purpose, it does not matter whether the related corporation leases the property directly from the DISC or indirectly from a lessee of the DISC. In either case, the property is not to be considered export property.

Finally, the bill provides that patents, inventions, models, designs, formulas, or processes, whether or not patented, copyrights (other than films, tapes, records, or similar reproductions, for commercial or home use), good will, trademarks, trade brands, franchises, or other like property are not export property. Although generally the sale or license of a copyright does not produce qualified export receipts (since a copyright is generally not export property), the sale or lease of a copyrighted book, record, or other article does generally produce qualified export receipts.

Producer's loans.—As indicated previously, a DISC is to be permitted to loan its tax deferred profits back to its parent manufacturing company (or any other U.S. export manufacturing corporation), generally, as long as the cumulative amount loaned to any one borrower does not exceed the amount of the borrower's assets considered as being related to its export sales. This in essence is the same proportion of the borrower's assets that its export sales are of its total sales. These loans—termed "producer's loans"—are to constitute qualified export assets of a DISC and the interest arising on the loans is to represent a qualified export receipt of a DISC.

For a loan of a DISC's tax deferred profits to constitute a producer's loan, the loan must be made to a borrower who is engaged in the manufacturing, production, growing, or extraction of export property in the United States and at the time the loan is made it must be designated as a producer's loan. In addition, the loan must be evidenced by a note (or some other evidence of indebtedness) and must have a stated maturity of not more than 5 years. If a loan which qualifies as a producer's loan is not collected by the DISC when it matures or is extended at maturity for a period which does not have a fixed time limit, the loan is to cease to qualify as a producer's loan at its original maturity.

To qualify as a producer's loan, a loan must be made out of the DISC's tax deferred profits—its accumulated DISC income. A loan is to be considered as made out of accumulated DISC income if at the beginning of the month in which the loan is made, the amount of the loan, when added to the unpaid balance of all other producer's loans previously made by the DISC, does not exceed the DISC's accumulated DISC income.

As indicated above, a limitation is placed on the amount of a DISC's tax deferred profits which may be loaned to any one borrower, which in general is the amount of the borrower's assets treated as export related. To the extent a loan exceeds the borrower's limitation, it is not to be considered a producer's loan. Whether a loan of a DISC's tax deferred profits to a borrower is within the borrower's limitation is to be tested at the time the loan is made by adding the amount of the loan to the unpaid balance of all other producer's loans of the borrower outstanding at that time and comparing this amount to the borrower's limitation.

The limitation imposed on the amount of loans which a borrower may receive during a taxable year of the borrower is to be determined by applying the percentage, which the borrower's export receipts arising from its sale of export property during the three prior taxable years is of its aggregate gross receipts from the sale of inventory property during that period, to the total of the borrower's assets taken into account for this purpose. In no event, however, are the receipts of a taxable year beginning before 1972 to be taken into account in determining this percentage.

There are three categories of a borrower's assets which are taken into account in determining this limitation for a year: (1) the amount of the borrower's investment in plant, machinery, equipment and supporting production facilities in the United States as of the beginning of its taxable year (taken into account at its adjusted basis at that time); (2) the amount of the borrower's inventory at the begining of the taxable year (taken into account in the manner in which the borrower normally values its inventory); and (3) the aggregate of the borrower's research and experimental expenditures in the United States during all preceding years of the borrower which began after 1971.

In addition to the requirements discussed above, a loan can qualify as a producer's loan only to the extent that the DISC is able to show that at the end of the year of the loan the borrower increased its inventory, plant, machinery, and equipment, and research and development expenditures in the United States for that year by an amount equal to the loan.

If a loan of a DISC's accumulated DISC income qualifies as a producer's loan under the requirements and limitations described above at the time when the loan is initially made, it is to remain a producer's loan until its maturity. If at its maturity the borrower's limitation is sufficient to permit a new loan in the amount of the old loan, then the old producer's loan could be renewed for an additional stated period of up to 5 years and then would qualify as a producer's loan for that period. The fact that a borrower's allowable level of producer's loans decreases after the time it received a particular producer's loan does not affect the qualified status of that loan. On the other hand, a loan which does not qualify as a producer's loan at the time it is made does not subsequently become a producer's loan by reason of an increase in the borrower's limitation.

Where a borrower is a member of a controlled group of corporations, the limitation may be determined at the borrower's election by taking into account the export sales and export-related assets of the group of corporations (other than any member of the group which is a DISC).

A separate limitation from that described above may be used in the case of a borrower who is a domestic film maker. In order for a loan to be considered a producer's loan in the case of a domestic film maker with respect to a film, the studio used for filming and for recording sound must be located in the United States, at least 80 percent of the aggregate playing time of the film must be photographed within the United States, and at least 80 percent of the total amount paid for services performed in the making of the film must be paid to persons who are U.S. persons at the time they perform the services (or consists of amounts which are fully taxable by the United States). Since whether a loan qualifies must be determined at the time the loan is made, the 80-percent-of-amount-paid requirement does not include any amount contingent upon receipts or profits of the film because these items are unpredictable at that time. Where a nonresident alien individual or corporation is engaged to furnish the services of one of its officers or employees in the making of the film, the amount paid may be counted toward the 80-percent test if it is fully taxable by the United States and not exempt from taxation under any provision of law or treaty.

This limitation on the amount of the loan is to be determined by taking into account the domestic film maker's current plant and equipment, inventory, and research and development expenditures plus any assets of this type which will be acquired at any time by the film maker with respect to films commenced during the year in which the loan is made. The portion of these assets which are considered export-related (which is the limit on the amount of the producer's loan which may be made) is to be determined by reference to the export experience of other producers of similar films. It is anticipated that industry statistics will be used for determining the relevant experience of other producers in this regard.

Related foreign export corporations.—To take account of the fact that a DISC may find it helpful or even necessary in conducting its exporting business to have certain types of foreign investments, the bill provides that a DISC is to be permitted to own stock or securities in three types of foreign corporations. In other words, stock or securities of this type are to be qualified export assets and the dividends or interest arising on the investment are to be qualified export receipts.

The three types of foreign corporations in which a DISC may own stock or securities are—

(1) a foreign international sales corporation (or FISC), which in essence is a foreign selling arm of the DISC principally engaged in marketing export property;

(2) a real property holding company, which in general is a foreign company that holds title to real property used by the DISC which the DISC cannot own directly because of the requirements of the applicable foreign law; and

(3) an associated foreign corporation, which generally is a foreign customer of the DISC in which it must invest as a means of extending to the customer the export credit which is needed to effect the export sale or sales.

For a foreign corporation to qualify as a FISC, more than 50 percent of its voting power must be directly owned by the DISC and 95 percent of its gross receipts and assets must be related to U.S. exports. For this purpose, the foreign corporation's U.S. export-related receipts consist only of its gross receipts from qualified export sale, lease, or rental transactions and related and subsidiary services, and receipts from the sale of other qualified export assets. The corporation's export-related assets consist only of its inventory of export property, its facilities for the sale, lease, rental, assembly, etc., of export property, its accounts receivable which arise by reason of qualified export sales, leases, rentals, or related and subsidiary services, and its working capital related to its export business and represented by money, bank deposits, and other similar investments.

A real property holding company is a foreign corporation in which a DISC directly owns more than 50 percent of the voting power and the exclusive function of which is to hold real property for the exclusive use of the DISC. The real property may be used by the DISC under a lease or other type of arrangement.

For a foreign corporation to qualify as an associated foreign corporation, the DISC's ownership of stock or securities in the foreign corporation must be reasonably in furtherance of transactions which produce qualified export receipts for the DISC (as determined under regulations prescribed by the Secretary of the Treasury).[4] In addition, for a foreign corporation to qualify as an associated foreign corporation, the portion of its voting power which is owned either by the DISC or by a controlled group of corporations which includes the DISC must be less than 10 percent. In determining the amount of voting power in the foreign corporation which is owned by the DISC or controlled group for this purpose, the attribution rules of section 1563 (d) and (e) are to apply.

Gross receipts.—The bill provides that the term gross receipts means in the case of sales, leases or rentals of inventory, the total receipts arising on the sale, lease or rental. In the case of other types of transactions, gross receipts is to include only the gross income arising on the transaction. For example, in the case of a sale by a DISC of an ex-

[4] Generally, this ownership will be considered as being in furtherance of transactions giving rise to a qualified export receipt if the ownership is necessary to maintain or obtain a customer or is to aid the sales distribution system of the domestic corporation. However, the investment in the foreign corporation must be reasonable in amount as compared to the value of the business which can be expected to be derived due to such ownership.

port-related asset (other than inventory), the gross receipts arising on the sale would be the gain realized.

To make the treatment of sales (leases or rentals) which the DISC makes on a commission basis comparable to the treatment of sales (leases or rentals) by the DISC of property which it has purchased, it is provided that in the case of a commission sale, the DISC's gross receipts are to be the gross receipts on the sale (lease or rental) of the property to which the commission relates, rather than just the amount of the commission. The time when the receipts on a commission sale (lease or rental) arise is to be determined under the commission arrangement and the accounting method otherwise employed by the DISC. For example, in the case of a deferred payment sale, if under the DISC's accounting method it would be considered as having received the entire commission in the year of sale, then the entire amount of gross receipts to which the commission relates is to be considered as received in that year, even though actual payment is not made until subsequent years. On the other hand, if under the DISC's method of accounting, it would be considered as having received the commission only as the payments for the property sold were received in future years, then the gross receipts on the sale are to be considered as received in each subsequent year to the extent they relate to the commission which the DISC is considered as receiving in that year.

United States defined.—The bill provides that for purposes of the new DISC provisions, the term United States is to include possessions of the United States. In other words, for this purpose, the United States includes Puerto Rico, American Samoa, Guam and the Virgin Islands. As a result, property "exported" to U.S. possessions is not to be considered as export property and a related foreign export corporation may not be organized in a possession. On the other hand, property imported into the United States from a U.S. possession, which is subsequently incorporated in property to be exported, is not to be considered a foreign item in determining the foreign content of the property exported.[5]

5. *Intercompany pricing rules (sec. 501 of the bill and sec. 994 of the code)*

Under the intercompany pricing rules of present law, a sale to a related person generally must be made on an arm's length basis (i.e., the price charged the related person must be essentially the same as that which would be charged an unrelated third person). Your committee believes it is desirable to avoid the complexities of the present pricing rules in the case of sales by a domestic parent corporation (or other entity considered related under section 482) to a DISC and also to provide encouragement for the operation of DISC's. In view of this, your committee has provided two pricing rules which may be used in determining the permissible profits—although in excess of profit under arm's length rules and regardless of the sales price actually charged—which a DISC may earn on products which it purchases from a related company and then resells for export. Of course, in any case where the arm's length pricing rule would allow a greater allocation of profit to

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[5] Since a DISC must be organized under the laws of a State, a corporation is not a DISC for purposes of U.S. taxes if it is organized under the laws of a possession.

the DISC than would the new rules, that rule will continue to be applicable.

Under the first of the two new rules, a DISC may earn that portion of the combined taxable income arising on the sale by a DISC of export property purchased from a related person which does not exceed 4 percent of the qualified export receipts from the sale, plus 10 percent of the DISC's export promotion expenses attributable to the sale. Income may not, however, be allocated to the DISC under this (or the second) rule to the extent it would result in the related person who sold the products to the DISC incurring a loss on the sale.[6]

Under the second pricing rule provided by the bill, a DISC may earn up to 50 percent of the combined taxable income of the DISC and the related person arising from the sale of the property, plus an additional amount equal to 10 percent of the DISC's export promotion expenses attributable to the sale. For this rule, the combined taxable income from the sale of the export property is to be determined generally in accordance with the principles applicable under section 861 for determining the source (within or without the United States) of the income of a single entity with operations in more than one country. These rules generally allocate to each item of gross income all expenses directly related thereto, and then apportion other expenses among all items of gross income on a ratable basis. Thus, the combined taxable income of a DISC and a related person with respect to the sale by the DISC of export property would be determined by deducting from the DISC's gross receipts the related person's cost of goods sold with respect to the property, the selling, overhead and administrative expenses of both the DISC and the related person which are directly related to the production or sale of the export property and a portion of the related person's and the DISC's expenses not allocable to any specific item of income, such portion to be determined on the basis of the ratio of the combined gross income from the export property to the total gross income of the related person and the DISC.[7]

Although both of the pricing rules provided by the bill generally are to be applied on a product-by-product basis, the rules may be applied on the basis of product lines.

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[6] The pricing rule described above can be illustrated by a DISC which sold export property it purchased from a related person for $100, and incurred export promotion expenses attributable to that sale of $10. In this case, there could be allocated to the DISC that part of the combined taxable income arising with respect to the export property which did not exceed $5 (4 percent of $100 plus 10 percent of $10). This profit element of $5 plus the promotion expenses of $10 indicates that the transfer price of the related person to the DISC in this case could be $85 ($100 less the $10 of promotion expenses and the $5 of DISC profit). If the combined taxable income arising on the sale (i.e., the receipts of the DISC on the sale less the parent's cost of goods sold for the property and the applicable other expenses of the parent company and the DISC) were only $4, then the amount of profit allocated to the DISC on the sale may not exceed $4.

[7] For example, assume the DISC's selling price was $1,000, the cost of goods sold of the related person $650, the directly related selling and administrative expenses $150, including $90 of export promotion expenses incurred by the DISC, and indirect expenses prorated to the export income of $30 (assuming total unallocable expenses of $300, $3,500 total gross income of the related person and the DISC (excluding the transfer price paid by the DISC) and $350 combined gross income from the export property ($1,000 gross receipts less $650 cost of goods sold), so that $300×$350/$3.500=$30). This indicates a combined taxable income of $170 ($1,000 less $650 and $180). In this case, the DISC would be allowed a taxable income of $94 (50 percent of the combined taxable income of $170 or $85 plus $9, representing 10 percent of the export promotion expenses it incurred). Accordingly, the related person would be allowed a taxable income of $76. This represents one-half of the profit of $170 less the $9 allocated to the DISC because of its export promotion expenses. This indicates that the related person could charge a transfer price to the DISC of $816 ($650, cost of goods sold ; $60, selling and administrative expenses ; $30, indirect expenses ; and $76, taxable income). The DISC would realize a gross profit of $184 and after deduction of the $90 export promotion expenses, a taxable income of $94.

Where a DISC is attempting to establish a market abroad, or seeking to maintain a market abroad, for exports, the Secretary of the Treasury may prescribe by regulations special rules governing the allocation of expenses incurred on the sale of the export property for purposes of determining the combined taxable income of the related person and the DISC. It is expected that in the appropriate cases the regulations will allow, for purposes of applying the second pricing rule, the combined taxable income on the sale of export property to reflect a profit equal to that which the DISC and a related party would earn if they took into account only the marginal costs of producing the property. The production expenses not considered marginal costs in this case would, of course, be allocable to the production of the related party which is not sold to the DISC.

These rules do not apply to sales to a DISC by a person who is not a related person (within the meaning of sec. 482), nor do they apply to sales by a DISC to another person. As a result, sales by a DISC to a foreign person will be subject to the regular pricing rules (sec. 482). This will insure that income is not diverted to foreign subsidiaries by underpricing on sales by a DISC to foreign affiliates.

The bill also provides that the Secretary of the Treasury may prescribe by regulations intercompany pricing rules, consistent with those provided by the bill, in the case of export transactions where the DISC does not take title to the property, but instead, acts as commission agent for the sale, or is a lessee of the property which it then subleases to its customers.

As indicated above, a DISC under either of the pricing rules may earn additional profit on the sale of export property purchased from a related person equal to 10 percent of the DISC export promotion expenses attributable to the sale. This rule is designed to encourage the transfer of a greater amount of selling functions and activities to DISC's. For purposes of this rule, export promotion expenses include 50 percent of the freight expenses (not including insurance) for shipping export property aboard U.S.-flag vessels except that these expenses may not include any incurred where law or regulation require that the export property be shipped aboard U.S.-flag vessels. Export promotion expenses also include a DISC's ordinary and necessary expenses paid or incurred to obtain the qualified export receipts. These expenses include advertising, salaries, rentals, sales commissions, warehousing and other selling expenses. They do not, however, include income taxes or any expenses which do not further the distribution or sale of export property for use or consumption abroad.

6. Taxation of DISC income to shareholders (sec. 501 of the bill and sec. 995 of the code)

This provision deals with the basic rules for taxing the shareholders of a DISC. In general, it provides that shareholders are to be taxed on the income of the DISC when it is actually distributed. There are also three situations in which a DISC shareholder will be taxed on DISC income even though the income is not actually distributed.

The first situation in which a DISC shareholder will be treated as having DISC income occurs when certain amounts are deemed distributed in qualified years. There are four categories of income which are deemed to be distributed even though a valid DISC election is in effect. Three of these catagories involve situations in which a DISC receives income which does not arise from export. These are interest derived from producer's loans, gain recognized by a DISC on property (which is not qualified export property) transferred to it in a transaction in which gain was not recognized, and gain recognized by a DISC on depreciable property (whether or not it is a qualified export asset) transferred to it in a transaction in which gain was not recognized. The fourth type of deemed distribution during a qualified year relates to the incremental tax deferral approach embodied in your committee's bill. The shareholders of a DISC are deemed to have received that portion of the taxable income of a DISC for the current year which is attributable to "base period export gross receipts." Generally speaking, this is that portion of a DISC's gross receipts which does not represent an increment over the export experience for 1968, 1969, and 1970 of corporations related to the DISC.

Treating these types of income as deemed distributions has the effect of denying them tax deferral treatment—which is appropriate since the income neither is export related nor does it consist of new exports.

The second situation in which a deemed distribution arises is where a corporation no longer qualifies as a DISC—because the corporation terminates its election or fails to meet the qualification requirements with respect to any year. In these cases, the DISC income on which tax has previously been deferred is deemed distributed, generally in equal installments over 10 years (or such shorter period of time as the corporation was a DISC). The intent of this is to terminate tax deferral when a corporation no longer qualifies as a DISC.

There is a third situation in which income is taxed to the shareholders of a DISC. This occurs when a shareholder disposes of stock in a corportion with tax deferred DISC income. Under usual rules he would be treated as having a capital gain in such a case to the extent the amount he receives exceeds his cost or other basis in the stock. However, in this case, since the tax on the DISC income has been deferred, the value of the stock at the time of sale reflects this tax deferred income. To prevent this tax deferred income from being converted into capital gain in these cases, the bill provides that this gain is to be classified as ordinary income to the extent of the tax deferred DISC income attributable to the stock. Similarly, where stock in a corporation which is, or was, a DISC is disposed of in a transaction in which the existence of the corporation is terminated, gain is to be recognized (even though it would otherwise be tax free) and the gain is to be ordinary income to the extent of the tax deferred DISC income attributable to the stock.

General rule.—The income of a DISC is to be taxed to its shareholders when it is actually distributed, deemed distributed, or in effect realized by a shareholder through a transaction such as a sale of his stock at a gain which reflects the accumulated income.

Deemed distributions in qualified years.—Although the bill generally provides for the deferral of tax on the profits of a DISC until an actual distribution is made, in the case of four types of income received by a DISC, tax is imposed currently. The current taxation is accomplished, however, not by taxing the income to the DISC but rather by taxing it to the shareholders of the DISC as if the income had been distributed to them. These deemed distributions for a year, however, are not to exceed the DISC's earnings and profits for the year. When amounts which are deemed distributed to a DISC's shareholders are actually distributed to them, the actual distributions are to be tax free.

First, each shareholder of a DISC is deemed to receive an annual distribution equal to his pro rata share (based upon his ownership of DISC stock) of the gross interest income received by the DISC on its producer's loans.

Second, the shareholders of a DISC are deemed to have received a pro rata distribution upon the sale by the DISC of property (which is not an export asset in its hands) transferred to it in a tax-free exchange. The amount deemed distributed is not, however, to exceed the transferor's gain not recognized on the previous transfer to the DISC. This rule is designed to prevent the transfer of appreciated property, which would not be an export asset to the DISC (e.g., stock or securities in a corporation other than a related foreign export corporation), to be followed by the sale by the DISC of the transferred property. Without a rule of this type, the DISC would not be taxed on the gain arising from the sale, even though it may have been considered to be a nonqualified export receipt.

Third, a DISC's shareholders are to be deemed to have received a pro rata distribution upon the sale by the DISC of depreciable or other property (other than inventory) which it received in a tax-free transaction. The distribution in this case is equal to the amount of the gain realized by the DISC, but only to the extent there would have been ordinary income if the property had been sold by the person who transferred it to the DISC at the time of the transfer. This rule basically is designed to prevent the transfer of depreciable property to a DISC in a transaction in which gain is not recognized followed by the sale by the DISC of the property. In the absence of this rule, the DISC would not be taxed on the sale and the depreciation recapture effect (as provided for in sections 1245 and 1250), which would give rise to ordinary income treatment if the sale had been made by the transferor, would be avoided.

These latter deemed distribution rules are to apply where property is contributed to a DISC as a contribution to capital and also in the case of nonrecognition exchanges.[8] In addition, if a transferor recognizes any gain as the result of the transfer of property to a DISC (due, for example, to the receipt of "boot" in a section 351 exchange), that recognized gain is to be taken into consideration in determining the amount of the deemed distribution resulting from the sale by the DISC of the transferred property.[9]

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[8] For example, assume a U.S. corporation acquires data processing equipment at an original cost of $150,000. Assume the corporation transfers the equipment to its wholly owned DISC, as a contribution to capital, when the adjusted basis of the equipment is $110,000 and its fair market value is $130,000. Assume further that the DISC is entitled to depreciation deductions of $40,000. At the end of a 2-year period, the DISC sells the equipment for $120,000 and as a result realizes a gain of $50,000 ($120,000 less $70,000). If the equipment had been sold by the parent at a time of the transfer, instead of transferred to the DISC, it would have realized $20,000 ordinary income pursuant to the depriciation recapture rules (sec. 1245). Accordingly, $20,000 of the $50,000 gain realized by the DISC on the sale of the equipment is to be treated as a deemed distribution to the parent.

[9] For example, if section 1245 property (with respect to which depreciation in the amount of $20 has been taken) with an adjusted basis to the transfer or of $80 and a fair market value of $100 is transferred to a DISC in return for stock and "boot" in the amount of $10, the subsequent sale of the transferred property by the DISC for $105 will result in a realized gain to the DISC of $15 (assuming it took no depreciation deductions with respect to the property) of which $10 will be considered a deemed distribution.

Fourth, DISC shareholders are to be deemed to receive the portion of the taxable income of the DISC for the year which is attributable to "base period export gross receipts." Taxing this amount of the DISC's income currently to its shareholders in effect makes tax deferral available for the DISC income only to the extent that the DISC's (and related companies') export gross receipts for the current year exceeds 75 percent of their average export gross receipts for 1968, 1969, and 1970. The manner in which the amount deemed distributed under this provision is determined, and the factors to be taken into consideration in determining the base period export gross receipts, are discussed below.

As indicated subsequently, deemed distributions in qualified years are not to be eligible for the dividends received deduction since the income will not have been taxed to the DISC. These deemed distributions to a DISC's shareholders are to be treated as received by the shareholders on the last day of the taxable year of the DISC in which the income in question was derived (according to the DISC's method of accounting).

Deemed distributions upon termination or disqualification.—The deferral of tax on a DISC's income provided by the bill continues as long as the corporation is a DISC. However, when the corporation terminates its DISC election or fails to qualify as a DISC, the bill provides that its accumulated DISC income (its earnings and profits accumulated while it was a DISC) are to be deemed distributed pro rata to its shareholders.

Following termination or disqualification each shareholder is deemed to receive a distribution equal to his pro rata share of the DISC income of the corporation accumulated during the immediately preceding consecutive years for which the corporation was a DISC.

To avoid the taxation in one year of income accumulated over a period of years, the bill provides that amounts deemed distributed to the shareholders of a DISC which terminates its election or disqualifies are to be treated as received in equal installments over a 10-year period beginning with the year following the year of termination or disqualification. If the number of consecutive years during which the corporation qualified as a DISC immediately prior to the termination or disqualification was less than 10, then the deemed distributions are to be treated as received over that smaller number of years. These deemed distributions are considered received by the shareholders on the last day of the corporation's taxable year in which they are deemed made. For example, if a corporation qualifies as a DISC for the taxable years 1972 through 1975, but disqualifies in 1976, its shareholders are to treat their deemed distribution as received in equal installments on the last day of the four taxable years of the corporation beginning with the year 1977.

Deemed distributions upon termination or disqualification are to continue and are to be included in income by the shareholders even though the corporation subsequently requalifies as a DISC. For example, if the corporation in the above illustration requalifies as a DISC for the calendar year 1977, this is not to affect the deemed distributions occurring as a result of the prior termination or disqualification.

If during the period the DISC income is being deemed distributed, an actual distribution of that DISC income is made, it is to first reduce the last installment of the deemed distributions, and then the preceding installments in reverse order.[10] If deemed distributions are being received for two or more disqualifications, an actual distribution affects the deemed distribution resulting from the earlier disqualification first.

Deemed distributions resulting from disqualifications or termination are includible in a shareholder's income only while he continues to hold stock in the corporation. In other words, if the shareholder disposes of his stock, the distributions after the disposition will be deemed received by the shareholder's successor in interest, rather than the selling shareholder. As discussed subsequently, the disposition itself may result in the taxation of the DISC income to the shareholder and also render future deemed distributions to his successor in interest nontaxable.

Gain on the disposition of DISC stock.—Your committee's bill provides that when stock in a DISC (or former DISC) is disposed of in either of two types of transactions, the disposing shareholder is to be taxed as if he received a dividend on his share of the accumulated DISC income, generally to the extent of the gain realized on the disposition. The amount attributable to the DISC income is to be treated as a dividend.

The first type of transaction covered by this provision is one in which the shareholder disposes of his stock in a DISC (or former DISC) where gain is recognized. The second type is a nonrecognition of gain transaction (such as a parent-subsidiary liquidation) in which the DISC (or former DISC) ceases to exist as a separate corporate entity. In these cases, the shareholder of the DISC, by realizing gain on the disposition of his stock in an amount which reflects the accumulated DISC income is, in effect, in much the same position as if he had actually received that income.

The first type of transaction—disposition of stock where gain is recognized—includes, of course, the sale of stock of a DISC (or former DISC). In such a case, the gain realized by the seller is to be treated as a dividend to the extent of the corporation's accumulated DISC income attributable to the stock sold. Thus, if a shareholder, whose share of the corporation's accumulated DISC income is $30, sells his DISC stock, which has a basis of $50, for $100, $30 of the realized gain of $50 is to be treated as ordinary income. If the stock had been sold for $70, the entire realized gain of $20 would be treated as ordinary income. In determining the accumulated DISC income attributable to the stock disposed of, it is intended that the DISC income for the year of disposition, although determined at the close of the DISC's taxable year, is to be prorated over the year and only

[10] For example, assume that as a result of the disqualification of a DISC in 1976 after four years of qualification, a shareholder is to be deemed to receive $5,000 in each of the four succeeding taxable years (1977, 1978, 1979 and 1980). If the shareholder receives a $6,000 actual distribution during 1977 out of DISC income accumulated during the consecutive years immediately prior to the disqualification, the distribution is to be treated as follows. First, it is to eliminate the 1980 deemed distribution and then it is to reduce the 1979 deemed distribution to $4,000. Thus, in 1977, the shareholders will include $11,000 in gross income (the $5,000 deemed distribution for 1977 and the $6,000 actual distribution). In 1978, the shareholder will be taxed on the $5,000 deemed distribution for that year, and in 1979 will be taxed on the final deemed distribution of $4,000.

that portion attributable to the period prior to the disposition is to be taken into account in determining the amount attributable to the shares disposed of.

Gifts during lifetime of DISC stock or transfers by reason of death of DISC stock are not to result in ordinary income treatment to the transferor since there is no gain realized on the disposition. On the other hand, gain on the redemption of a shareholder's stock by a DISC (e.g., one that is in complete termination of the shareholder's interest or one that is substantially disproportionate) is to be treated as ordinary income (rather than capital gain) to the extent of the DISC income attributable to the shares redeemed. Transactions which produce partial recognition, such as the transfer of DISC stock to a corporation in exchange for stock and "boot," also are within this category. In this case, the gain recognized as a result of the receipt of "boot" is to be treated as ordinary income to the extent of the DISC income attributable to the transferred DISC stock.

Among the transactions within the second type which result in ordinary income to the shareholders of a DISC are "A" or "C" reorganizations where the DISC ceases to exist as a separate entity. For example, if a corporation acquires the assets of a DISC in an "A" or "C" reorganization and the shareholders of the DISC exchange their stock for stock of the acquiring corporation (with the DISC ceasing to exist as a separate entity), the gain realized on the transaction by the DISC shareholders is to be recognized and taxed as ordinary income (notwithstanding the nonrecognition treatment otherwise accorded to these transactions) to the extent of the accumulated DISC income attributable to their stock. The liquidation of a DISC subsidiary is another example of a transaction which falls within the second type of transactions which results in ordinary income treatment. Thus, if a parent corporation liquidates its wholly owned DISC (which would normally be entitled to nonrecognition under section 332), gain is to be recognized and treated as ordinary income to the extent of the subsidiary's accumulated DISC income.

A "B" reorganization, on the other hand, usually will not be within the second category since the DISC usually will remain in existence. Accordingly, the shareholders of a DISC who exchange their stock for the stock of an acquiring corporation in a "B" reorganization would be entitled to the generally applicable nonrecognition of gain treatment. The acquiring corporation would step into the shoes of the former DISC shareholders and the DISC (the acquired corporation) would maintain its status as a DISC.

There are other types of corporate adjustments generally accorded nonrecognition treatment in which the DISC will survive and thus will not have ordinary income tax consequences for the DISC shareholders. For example, assume a DISC is "split-up" into two corporate entities, in a manner which would be treated as a tax-free reorganization. Since the DISC survives (although as two separate DISC's), the shareholders of the DISC who exchange their stock for stock in one of the two surviving corporations (each of which will qualify as a DISC) will not, as a result of the split-up, be treated as having ordinary income by reason of the DISC rules. The accumulated DISC income of the DISC, and other attributes, will be allocated among the surviving corporations in accordance with regulations promulgated by the Treasury. In addition, the bill provides that a mere change in a DISC's place of incorporation (which would constitute a tax-free "F" reorganization) is not to be considered as terminating the DISC existence and thus is not to have ordinary income tax consequences for the DISC's shareholders. The newly incorporated DISC would step into the shoes of the DISC incorporated in the other jurisdiction.

The ordinary income treatment provided by the bill on the disposition of stock in a DISC is intended to apply only to the extent that the recognized gain is not, under another provision of the code, treated as a dividend or as gain from the sale of an asset which is not a capital asset. For example, assume that a shareholder of a DISC exchanges his stock in a "C" reorganization for stock of the acquiring corporation and receives "boot" which causes a portion of the shareholder's gain to be treated as a dividend (under the "boot dividend" rule of section 356(a)(2)). The ordinary income treatment provided by the bill is to apply to the shareholder's gain on the exchange of his stock only to the extent the gain realized exceeds the amount treated as a dividend under the "boot dividend" rule.

Determination of taxable income attributable to base period export gross receipts.—The amount of a DISC's taxable income for the current year which is attributable to the base period export gross receipts of the DISC (and related companies), and which therefore is to be deemed distributed currently to the DISC's shareholders, is that portion of the income which the base period export gross receipts of the DISC (and related companies) bears to the current year's export gross receipts of the DISC (and related companies). For example, assume that a parent corporation had base period export gross receipts of $100. In 1972, the corporation forms a DISC as a subsidiary. During that year the parent corporation has export receipts of $110 and the DISC has export gross receipts of 40. Assume further that the DISC's taxable income in 1972 is $6. The amount of the $6 of taxable income which is attributable to base period export gross receipts is determined by multiplying the $6 amount by $100/$150 (the base period export gross receipts of the parent company over the total current export gross receipts of the DISC and the parent company). Consequently, two-thirds, or $4, of the taxable income of the DISC is attributable to base period export gross receipts and is, therefore, deemed to be distributed by the DISC's shareholders and currently taxed to them.

The base period for purposes of this deemed distribution rule is 1968, 1969, and 1970 (in the case of corporations with fiscal years, the taxable years ending in 1968, 1969, and 1970), or that part of the period during which the company in question was in existence.

Base period export gross receipts are 75 percent of the average gross receipts during the base period from the sale, lease or rental of property (held primarily for sale, lease or rental to customers) for use outside the United States and receipts for engineering or architectural services on construction projects located (or proposed for location) outside the United States. If a taxpayer so elects, it may compute base period export gross receipts by taking into consideration only its sales, leases or rentals of property which would have been export property if held by a DISC. Assume for example, that a substantial part of a corporation's export receipts during the base period arose from the sale of property, more than 50 percent of the value of which was attributable to articles imported into the United States. This property, if held by a DISC, would not have been qualified export property. Consequently, if a taxpayer can demonstrate to the Internal Revenue Service which of his gross receipts were not attributable to the sale, lease or rental of qualified export property (as defined in sec. 993(c)), it accordingly will be able to reduce its base period export gross receipts.

The companies whose base period export gross receipts are taken into account for purposes of this deemed distribution rule are those corporations which are related in the current year to the DISC in question. (A company is considered related to a DISC if both are members of the same controlled group of corporations as defined in section 1563 (a), but with a 50-percent, rather than an 80-percent, ownership requirement). The base period export gross receipts of a company related to the DISC in the current year are taken into account whether or not it was a related company during the base period. For example, assume a corporation forms a subsidiary which is treated as a DISC. If the parent corporation later acquires the stock of another corporation (in a taxable or nontaxable transaction), the base period experience of the newly acquired corporation is to be taken into consideration in determining the base period export gross receipts of the DISC and related companies for the current year.

The bill also provides for the carryover of base period export gross receipts when a corporation acquires the assets of another corporation in either a taxable or nontaxable transaction. For example, if one corporation is merged into another corporation, it is provided that the base period experience of the merged corporation is acquired by the surviving corporation. Also, if a corporation buys the assets of another corporation in a taxable transaction, it is provided that the purchasing corporation will take into account the base period experience attributable to the acquired business (as determined under regulations prescribed by the Treasury Department). Moreover, the Treasury Department is to prescribe rules for reducing the base period export gross receipts of a corporation which sells a portion of its assets to reflect the amount of gross receipts attributable to the assets sold. Further, the Treasury Department is to prescribe rules for the allocation of base period export gross receipts between parties involved in corporate separations.

The carryover rules provided by the bill apply in situations where assets are acquired either during or after the base period. For example, if a corporation acquires the assets of another corporation in 1974, the base period experience attributable to the acquired assets will be taken into account in determining base period export gross receipts with respect to a DISC formed by the purchasing corporation in 1975.

7. Special rules (sec. 501 of the bill and sec. 996 of the code)

A DISC corporation may have three different kinds of earnings and profits: the tax deferred income, called DISC income; income already taxed to the shareholders because of deemed distributions, called previously taxed income; and, then earnings and profits taxable to both the corporation and the shareholders, called other earnings and profits, which were earned when the corporation was not in a DISC status. This section is largely concerned with determining in the case of any particular distribution which of these types of income is to be considered as being distributed and how the distribution is to be treated.

Most actual distributions are considered as made first out of previously taxed income (to the extent of that income), then out of deferred DISC income (again, to the extent of this income), and, finally, out of other earnings and profits. Since the previously taxed income has already been taxed to the shareholders in deemed distributions, it is considered as distributed before the tax deferred DISC income. While this priority appears appropriate in the case of most actual distributions, it does not appear so in the case of distributions made to qualify for the 95 percent gross receipts or asset tests. To permit these qualifying distributions to be made out of previously taxed income would be inappropriate, since these are required because the receipts or assets involved are not export related. These distributions, therefore, are first considered as made out of the deferred DISC income and, only after other earnings and profits are distributed, as out of previously taxed income. Rules also are needed to determine which of these types of earnings and profits are absorbed by losses. These, of course, may, or may not, arise in a year in which a corporation is a DISC. When they arise in a non-DISC year, under the regular rules they reduce other earnings and profits. The bill, therefore, provides that losses are first to reduce other earnings and profits, then DISC income, and only finally income which has previously been taxed to the shareholders.

This section also contains a number of other rules necessary to the taxation of distributions to shareholders.

It provides, for example, for the order in which distributions are to be considered as made during the year. The first distributions made are deemed distributions. Next in order of priority are those made to provide qualification for the gross receipts and assets tests. This maximizes the likelihood of these being taxed to the shareholder. Last in order of priority are other actual distributions.

A second rule is necessary where ordinary income is taxed to a shareholder because of the sale of stock (or in the case of a taxable redemption of stock). As previously indicated, an ordinary income tax is imposed on the shareholder in such a case commensurate with the portion of his gain representing deferred DISC income at the corporate level. A rule is provided which, on an individual basis, in effect, to the extent of the ordinary income taxed to the shareholder, shifts DISC income to previously taxed income so the successor in interest of this stock will not be taxed on this income again when it is actually distributed by the corporation. In the case of the redemption of stock, essentially the same rule applies, except that because the payments are made by the corporation there is no need to transfer an amount to previously taxed income.

A third rule provides for the necessary change in basis for stock when a shareholder is taxed on a distribution which he does not receive and, subsequently, when he receives a distribution on which he is not taxed. In the first case, the basis for his stock goes up, since this is the equivalent of receiving the income and contributing it back to the corporation. In the second case, the basis of his stock goes down, since this is the equivalent of "a return of capital" from the corporation which is not taxed to the shareholder.

A fourth rule spells out the fact that earnings and profits consist of three divisions: DISC income; previously taxed income, which, as its name implies, represents the deemed distributions already taxed to the shareholder; and, then, other earnings and profits which arise in a year in which the corporation was treated as an ordinary corporation rather than a DISC.

Finally, a rule provides that where a nonresident alien or foreign corporation, estate or trust receives a distribution from a DISC or has gain taxed as ordinary income on the sale of stock, it is to be taxed in the same manner as if the individual were a resident or domestic corporation—otherwise, the deferred income in such cases might escape tax entirely. This is accomplished by designating this income as "effectively connected" to the conduct of a trade or business within the United States.

Treatment of actual distributions.—The bill provides that actual distributions by a DISC (or former DISC) to shareholders out of earnings and profits are to be considered as made, to the extent thereof, first out of previously taxed income, then out of accumulated DISC income and finally out of other earnings and profits of the corporation. The type of actual distribution referred to here does not include a distribution made in order to qualify as a DISC (sec. 992(c)).[11]

Accordingly, to the extent a DISC (or former DISC) has previously taxed income as a result of deemed distributions being taxed to shareholders, actual distributions are first considered as being made from this source (and, as subsequently indicated, to that extent are to be excluded from the shareholder's gross income [12] and are to reduce the basis of his DISC stock). Of course, amounts distributed out of previously taxed income reduce the amount of previously taxed income of the corporation.

To the extent a distribution to a DISC's (or former DISC's) shareholders exceeds the previously taxed income, the distribution is to be treated as out of the accumulated DISC income (and as subsequently discussed, is not eligible for the dividends received deduction, but is generally treated as foreign source income).

The priority rules provided by the bill assure that, in the case of actual distributions, shareholders of a DISC (or former DISC) will be able to receive from the DISC amounts attributable to the deemed distributions, on which they previously have been taxed, prior to receiving taxable distributions. On the other hand, the rules insure that the shareholders must pay a tax on the DISC's tax-deferred income before they may receive dividends from the other earnings and profits of a corporation which are eligible for the dividends received deduction.

Distributions to meet qualification requirements.—As previously indicated, a corporation seeking to qualify as a DISC which has an excess amount of nonqualified gross receipts or nonqualified assets, is

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[11] Actual distributions for this purpose also do not include distributions to which section 995(c) applies (e.g., a distribution in redemption of stock).

[12] However, to the extent the previously taxed income would reduce the shareholders basis below zero, capital gain is recognized.

nevertheless permitted to qualify as a DISC if it makes a distribution of the nonqualified amounts. Since these distributions are viewed as consisting of nonqualified receipts or assets, it is thought they should be currently subject to taxation. As a result, it is necessary to provide a different priority rule for this type of distribution than that which applies in the case of other types of actual distributions to a DISC's shareholders.

To insure that these distributions are currently subject to taxation, they are treated as made, first out of accumulated DISC income, then out of other earnings and profits, and finally out of previously taxed income, to the extent of each of these amounts.

Treatment of losses.—The bill provides that if a DISC (or former DISC) incurs a deficit in earnings and profits as a result of a loss, the deficit is to be charged first to the DISC's other earnings and profits, then to its accumulated DISC income, and finally to its previously taxed income, to the extent of each of these types of earnings. Since the DISC's other earnings and profits have already borne tax at the corporate level, the deficit is charged against those earnings and profits before it reduces the accumulated DISC income which has not yet been subjected to tax.[13]

Because it is desired that each period of qualification as a DISC be treated separately, and that the deemed distribution resulting from a disqualification or termination not be diminished by a deficit in earnings and profits occurring subsequent to the period of previous qualification, the bill provides that a deficit occurring subsequent to a period of qualification is not to be applied against the DISC income which it has been determined is to be deemed distributed to the shareholders as a result of a revocation of election or other termination.[14]

Treatment of deemed distributions.—Any deemed distribution to shareholders of a DISC (or former DISC) is to be included in the shareholders' gross income as a dividend and increase the corporation's previously taxed income. This treatment applies to deemed distributions during qualified years as well as deemed distributions occurring upon the termination or disqualification of a DISC.

The amount of a deemed distribution made to a DISC's shareholders, if it is a deemed distribution upon disqualification or termination, also reduces accumulated DISC income. However, there is no similar reduction in accumulated DISC income for amounts which are deemed distributions during qualified years since these were

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[13] For example, assume a corporation, which elected to be taxed as a DISC beginning in 1976, has the following earnings record:
1975—$50 of earnings and profits (prior to becoming a DISC)
1976—$10 of DISC income
$8 of previously taxed income
1977—$10 of DISC income
$8 of previously taxed income
1978—$10 of DISC income
$8 of previously taxed income
In 1979, assume that the DISC incurs a deficit in earnings and profits of $70. This deficit is charged first against other earnings and profits (exhausting that account) and next against DISC income. Thus the DISC, as of the beginning of 1980, would have DISC income of $10 and previously taxed income of $24.

[14] For example, if a corporation became disqualified as a DISC for 1979, at which time it had $30 of accumulated DISC income accumulated over the prior 3 years, the shareholders would be deemed to have received distributions equal to their pro rata share of the accumulated DISC income ratably over the following 3 years, or a total deemed distribution of $10 per year. If the corporation incurred a deficit in earnings of profits for 1979, the deficit would not affect the status of the three-$10 deemed distributions resulting from the disqualification. Instead, the deficit would be charged first to other earnings and profits of the corporation, if any, and then to the previously taxed income. Any amount of the deficit then remaining would be available to reduce earnings and profits arising in future years.

taxed currently and not initially included in accumulated DISC income.

For example, assume an existing corporation (with earnings and profits of $200) becomes a DISC effective for the year 1975. Assume in that year, and the two following years, the corporation has DISC income (as of the end of the year) and deemed distributions as follows:

	1975	1976	1977
DISC income	$50	$70	$80
Deemed distributions (resulting in previously taxed income)	10	15	20

Assume further that during 1977 the DISC makes a cash distribution to its shareholders in the amount of $280. (As discussed below, the bill provides that deemed distributions are considered to have been made prior to any actual distributions during the year.) Thus, for the year 1977, the shareholders will be deemed to have received a distribution of $20, which will be taxable as a dividend. Accordingly, as of the end of 1977, before taking the actual distribution into account, the DISC has previously taxed income of $45 resulting from the distributions deemed made by the corporation during the years in which it was a DISC. Since the actual distribution of $280 made during 1977 is considered to have been made first from previously taxed income, the shareholders will be entitled to exclude $45 of the distribution from income. The remaining portion of the distribution ($235) is considered to consist of $200 of DISC income, and finally of $35 of other earnings and profits.

Priority of distributions.—The bill provides that deemed distributions are considered to have been made prior to actual distributions made during the same taxable year. Insofar as actual distributions are concerned, distributions to qualify the corporation as a DISC are considered to have been made prior to any other actual distributions made during the same taxable year.[15]

Subsequent effect of previous disposition of DISC stock.—As discussed above, the bill provides that a shareholder who disposes of his stock in a DISC (or former DISC) must, in certain instances, treat his

[15] To illustrate the application of these priority rules, assume an existing corporation (owned by a single shareholder), with accumulated earnings and profits of $10, elects to be treated as a DISC. At the end of its first year of operation as a DISC, its has DISC income of $4 and previously taxed income of $2. In its next year of operation, it earns DISC income of $4. In April of that year, the DISC makes a qualifying distribution of $6 for the preceding year. In June, the stock of the DISC is acquired by another corporation in a tax-free "B" reorganization, which results neither in the recognition of gain nor in ordinary income treatment for the disposing shareholder. In September, the DISC makes an actual distribution to its new shareholder, the acquiring corporation, in the amount of $8. During the year the DISC received $2 of taxable income attributable to base period export gross receipts which is deemed to be distributed on the last day of the year. Of the three distributions (the $6 qualifying distribution to the first shareholder, the $8 actual distribution to the new shareholder, and the $2 deemed distribution to the new shareholder), the $2 deemed distribution is considered to have been made first. The deemed distribution thus is ordinary income to the new shareholder and increases previously taxed income by the same amount. The $6 qualifying distribution is considered to have been made next, and is considered to be entirely out of accumulated DISC income (sec. 996(a)(2)). Thus, the prior shareholder of the DISC will have ordinary income in the amount of the distribution and will not be entitled to the dividends received deduction with respect to such amount. The $8 actual distribution is considered to have been made last in order and is considered first out of previously taxed income, of which the DISC has $4, next out of accumulated DISC income of which the DISC has $2, and last out of other earnings and profits, of which the DISC has a sufficient amount to cover this portion of the actual distribution. Accordingly, the new shareholder would be considered, insofar as the actual distribution of $8 is concerned, as having received $4 tax-free from previously taxed income, $2 from DISC income (which would not be eligible for the dividends received deduction) and $2 from other earnings and profits (which would be eligible for the dividends received deduction).

gain realized as ordinary income to the extent of the accumulated DISC income attributable to the shares disposed of. Thus, to the extent of the gain treated as ordinary income the shareholder is treated as if he had received an actual distribution of accumulated DISC income. Since this ordinary income treatment arises only with respect to one shareholder, however, no adjustment is made at the corporate level to the accumulated DISC income or previously taxed income of the DISC. Adjustments at the corporate level reflect events affecting all the shareholders on a pro rata basis, rather than just one shareholder.

To provide appropriate treatment in the situation where only one shareholder is taxed on a portion of the corporation's accumulated DISC income by reason of a disposition of his stock the bill provides a special rule. Under this rule a subsequent holder of the stock is to have a special adjustment which, in effect, permits him to treat the receipt of a subsequent actual distribution (or a deemed distribution occurring as a result of the disqualification or termination of the DISC) of accumulated DISC income as if the distribution were made out of previously taxed income (and thus nontaxable) to the extent gain on the previous dispositions of the stock was taxed as ordinary income.[16]

This special adjustment rule continues to apply even though the stock is again transferred to another person.[17] It does not, however, apply with respect to gain on an acquisition by a DISC or former DISC of its stock or, in the event of such an acquisition, to gain on a transaction prior to the acquisition.

Since a redemption by a DISC of its stock is economically equivalent to the acquisition of the DISC stock by the remaining DISC shareholders, the bill provides in this case for a reduction in the corporation's accumulated DISC income to the extent of the ordinary income realized (as a result of sec. 995(c)) by the redeemed shareholder upon the redemption. If the redeemed shareholder was entitled to the special adjustment rule, the corporation's accumulated DISC income also is to be reduced by the amount of the special adjustment, i.e., the amount of the DISC income which the redeemed shareholder could have received tax-free.[18]

Adjustments to basis.—When a shareholder of a DISC (or former DISC) is taxed on a deemed distribution of an amount which remains in the corporation, it is in essence as if there had been an actual distribution of the amount to the shareholder followed by a contribution by him of the amount to the corporation's capital. In the latter case,

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[16] For example, assume that a shareholder in a DISC is required to treat $20 of his gain on the sale of his DISC stock as ordinary income. Although the accumulated DISC income and the previously taxed income of the corporation are not adjusted to reflect this ordinary income treatment, the purchaser is to treat up to $20 of a subsequent actual distribution (or a deemed distribution resulting from termination or disqualification) out of accumulated DISC income in the same manner as a tax-free distribution from previously taxed income. Thus, if the corporation made an actual distribution to the purchaser of $15 out of accumulated DISC income, he would not be taxed on this amount, even though the corporation itself had no previously taxed income.

[17] For example, if the purchaser, in the example in the preceding footnote, transferred his DISC stock by gift to his son after having received the $15 distribution from the DISC which was tax-free to him under the special adjustment rule, the son would become entitled to the special adjustment rule. The amount of the special adjustment, however, would only be the excess of the gain treated as ordinary income to the original seller upon the sale, $20, over the amount previously treated as if it were from previously taxed income ($15). Consequently, an actual distribution by the DISC to the son of an amount up to $5 would be treated as tax-free to him.

[18] For example, assume a DISC with $100 of accumulated DISC income redeems the stock of a shareholder who treats $25 of his recognized gain as ordinary income. Assume also that the redeemed shareholder, because of the special adjustment tax, could have received $30 of DISC income from the DISC tax-free. In this case, the accumulated DISC income of the corporation is to be reduced to $45 ($100 minus $55) as a result of the redemption.

the basis of the shareholder's stock in the corporation would be increased by the amount of the capital contribution. To provide the same treatment in the case of deemed distributions, the bill provides that the basis of a shareholder's stock in the corporation is to be increased by the amount taxed to him as a deemed distribution.

On the other hand, the tax-free receipt by a shareholder of a DISC or former DISC of an actual distribution out of previously taxed income is the equivalent of a tax-free distribution of capital which under normal rules would result in a reduction of the basis of his stock. Accordingly, it is provided that the basis of the shareholder's stock in the DISC is to be reduced by the amount received by him tax free from previously taxed income (including amounts received tax free pursuant to the special adjustment rule). If a distribution of previously taxed income exceeds the basis of the shareholder's stock, it is to be treated by him as gain from the sale or exchange of property.

Definitions of divisions of earnings and profits; treatment of deemed distributions.—The bill provides that the earnings and profits of a DISC (or former DISC) are to be divisible into three separate categories.

The first division, DISC income, consists of those earnings and profits on which tax has been deferred because of the corporation's classification as a DISC in the year the income was earned. Thus, DISC income for a taxable year is the earnings and profits of a DISC during that year before reduction for any actual distributions made during the year but after reduction for amounts deemed distributed currently in qualified years such as interest on producer's loans and taxable income attributable to base period export gross receipts.

These amounts are omitted from DISC income, since they are taxed currently to the shareholders of a DISC and, therefore, do not represent earnings of a DISC on which tax has been deferred. If a DISC, because of its ownership of stock in a controlled foreign corporation, must include any amounts in its gross income, as a result of the application of subpart F, these amounts also are to be included in the DISC income division of earnings and profits for the year included in the DISC's taxable income.

The second division of a DISC's earnings and profits is previously taxed income. The amounts in this division represent the total of the amounts previously taxed to shareholders as deemed distributions (under sec. 995(b)), including both distributions when the corporation was and was not qualified as a DISC. Thus, if a shareholder is deemed to have received a distribution as a result of the termination of a DISC election, or the failure of the corporation to qualify as a DISC, or if he received a deemed distribution related to a qualified year of a DISC, the amount of any such deemed distribution is to increase previously taxed iucome and, in the case of a deemed distribution resulting from termination or disqualification, reduce accumulated DISC income.

The third division of a DISC's earnings and profits, is referred to as "other earnings and profits." This has reference to those earnings and profits of a DISC which were accumulated while the corporation was not taxed as a DISC (i.e., in a year prior to the corporation's election, or subsequent to the election if it did not qualify for the year). These are the "normal" earnings and profits of a DISC which are the same as the earnings and profits of an ordinary corporation which never was a DISC. As a result, these earnings and profits when distributed are eligible for the dividends received deduction and are not treated as foreign source income.

Effectively connected income.—The bill treats all actual and deemed distributions and gains which are taxed as ordinary income, insofar as shareholders of a DISC who are nonresident aliens or a foreign corporations, trust, or estate are concerned, as effectively connected with the conduct of a trade or business conducted through a permanent establishment by the shareholder within the United States. The effect of this provision is to place distributions from a DISC (both deemed and actual) and gains on the disposition of DISC stock treated as ordinary income (pursuant to sec. 995(c)) in the category of income which is subject to U.S. tax, when received by nonresident aliens and a foreign corporation, trust or estate on a net income basis and at the regular rate of tax.

8. Special subchapter C rules (sec. 501 of the bill and sec. 997 of the code)

The amount distributed in the case of a distribution of property (as distinct from money) to a corporate distributee usually is measured by reference to the basis of the property distributed, rather than its fair market value as is the case with distributions to individuals. In addition, the basis of property received by a corporate distributee usually is the adjusted basis of property distributed in the hands of the distributing corporation. (See secs. 301(b)(1)(B), and 301(d)(2)). However, since the distribution of property from a DISC, out of DISC income or previously taxed income, is includable in the income of the recipient in full (or, in the case of previously taxed income, has previously been so included), without benefit of the dividends received deduction, it is more appropriate to treat the distributions under the same rules as apply to distributions to individuals. In this case, there is not the possibility of two taxes as there usually is where the dividends received deduction is not available and one corporation makes a distribution to another corporation.

Consequently, the bill provides that the rules applicable to distributions to an individual are to apply to distributions by a DISC to the extent they are out of DISC income or previously taxed income (but not to the extent they are out of other earnings and profits where there is the possibility of a double tax.) Thus, the amount of these distributions in property are to be measured by the fair market value of the property distributed and the basis of the property distributed in the hands of the corporate distributee is to be its fair market value at the time of the distribution. To the extent that the distribution is out of the other earnings and profits of a DISC, the normal rules of section 301 are to apply.

The special rule described above, of course, has application to distributions by a former DISC to a corporate distributee, to the extent the distributions are out of the corporation's accumulated DISC income or previously taxed income.

9. Dividends received deduction (sec. 502 of the bill and sec. 246(d) of the code)

Generally, a corporation receiving a dividend from a domestic corporation is entitled to a deduction (usually equal to 85 percent of the dividend) in computing its taxable income. This intercorporate dividends received deduction is designed to prevent, for the most part, the multiple taxation of corporate earnings as they pass from one corporation to another. Since a DISC is not, however, subject to taxation on its earnings and profits as a DISC, there is no reason to provide for an intercorporate dividends received deduction for dividends distributed to corporate shareholders of a DISC.

As a result, the bill provides that the dividends received deduction is not to be available to corporate distributees to the extent dividends from a DISC (or former DISC) are out of accumulated DISC income, or previously taxed income, or are a deemed distribution in a year in which a corporation qualifies as a DISC (under sec. 995(b) (1)).

If, however, the dividend is made out of other earnings and profits, a corporate distributee is to be entitled to a dividends received deduction in the same manner and to the same extent as under the rules applicable to a distribution from a regular corporation under existing law.

10. Foreign tax credit (sec. 502 of the bill and secs. 901(d) and 904(f) of the code)

The bill makes the foreign tax credit available to shareholders of a DISC (or former DISC) for any foreign income taxes paid by the corporation with respect to certain distributions (whether deemed or actual). This is accomplished by providing that dividends from a DISC (or former DISC) are to be treated as dividends from a foreign corporation to the extent the dividends are treated as from sources without the United States. An amendment to the source rules (adding sec. 861(a) (2) (D) to the code) provides that dividends from a DISC are to be considered to be from sources without the United States to the extent attributable (as determined under regulations to be prescribed) to qualified export receipts (other than interest from U.S. sources) of the DISC.

By treating dividends from a DISC (or former DISC) as from a foreign corporation, to the extent the dividends are attributable to qualified export receipts (other than United States source interest), a corporate shareholder becomes entitled to the "deemed paid" foreign tax credit (section 902 of the code) with respect to any foreign income taxes paid by the DISC (or former DISC).

The bill also contains a provision which prevents a DISC shareholder, which has elected the overall limitation on the foreign tax credit, from using its excess foreign tax credits to offset its U.S. tax liability on the income received from a DISC (which is treated as foreign source income to the extent it is attributable to export receipts). As is the case under existing law with respect to interest income, the bill provides that the tax credit limitation is to be applied separately with respect to DISC income. The bill further provides that the overall limitation will not apply with respect to dividends received from a DISC. Consequently, a DISC shareholder is not to be able to use excess foreign tax credits paid to a particular country (e.g., France) to offset its tax liability on the dividends received by it from a DISC. All dividends received from a DISC are considered to be received from one country. Thus, the bill provides that if a taxpayer receives dividends from more than one DISC the aggregate of the dividends is to be considered in applying the per country limitation on the foreign tax credit.

11. Western Hemisphere Trade Corporations (sec. 502 of the bill and sec. 922 of the code)

The bill provides that a corporation which is a DISC for a taxable year and which also would otherwise qualify as a Western Hemisphere trade corporation for the year is not to be allowed the special Western Hemisphere trade corporation deduction (which is equivalent to a 14 percentage point rate reduction) for that year. Denial of the deduction will insure that during this period a DISC does not receive the double benefit of Western Hemisphere trade corporation treatment and DISC treatment. The special deduction is available to a former DISC if it otherwise qualifies for the deduction.

In addition, the bill also provides that a corporation may not receive the special Western Hemisphere trade corporation treatment for any year for which it owns stock in a DISC or former DISC. It would be inappropriate to accord tax-deferred status to a DISC's profits when earned by the DISC and, in addition, the special Western Hemisphere trade corporation tax rates on those profits when they are distributed by the DISC.

12. Possessions' corporations (sec. 502 of the bill and sec. 931(a) of the code)

Under present law, a U.S. corporation is treated as a possessions' corporation if most of its income is derived from a possession. A possessions' corporation is taxable by the United States only on its U.S. source income. If a possessions' corporation were allowed this special treatment for a taxable year in which it was a shareholder in a DISC or former DISC, the tax-deferred profits of the DISC or former DISC which were distributed or deemed distributed to the possessions' corporation would be free of tax in the possessions' corporation's hands, since they are not treated as U.S. source income. To prevent this result, the bill provides that the special possessions' corporation treatment is not to be available to a corporation for any year in which it owns stock in a DISC or former DISC. The bill also provides that this treatment is not to be available when the corporation is, itself, a DISC.

13. Consolidated tax returns (sec. 502 of the bill and sec. 1504(b) of the code)

The bill provides that a DISC or former DISC may not be included in a group of affiliated corporations electing to file a consolidated tax return. An affiliated group of corporations which files a consolidated tax return, in effect, is allowed a 100 percent dividends received deduction on dividends flowing from one member of the group to another. The allowance of this treatment, like the allowance of the general dividends received deduction, is not compatible with the principle that earnings of a DISC are not to be taxed in the hands of the DISC but rather are to be taxed in the hands of its shareholders.

14. Special rule with respect to DISC stock acquired from a decedent (sec. 502 of the bill and sec. 1014(d) of the code)

In order to prevent the possibility of a DISC shareholder, who receives stock of a DISC (or former DISC) from a decedent, from escaping taxation on the DISC income attributable to those shares when they are disposed of by him, your committee has provided a special basis rule with respect to such stock when acquired from a decedent.

An amendment to the general basis rule relating to property acquired from a decedent (sec. 1014) provides that the basis given stock of a DISC (or former DISC) acquired from a decedent is to be the basis of the property determined under the general rule in such cases (fair market value upon the applicable estate tax valuation date) but reduced by the amount which would have been treated as ordinary income (under sec. 995(c)) had the decedent lived and sold the DISC stock at its fair market value on the applicable estate tax valuation date. Thus, the basis of DISC stock in the hands of an individual acquiring such stock from a decedent is still to reflect the potential taxation to such individual (as ordinary income) of the DISC income attributable to the acquired shares.

This rule can be illustrated by assuming that A, possessing DISC stock with a basis of $60 in his hands, dies when the stock has a fair market value of $100. Assume further that A's fiduciary elects the date of death valuation for Federal estate tax purposes. If the DISC income attributable to the inherited shares is $30, the basis of such stock to the legatee (B) would be $70 (the fair market value at death, $100, reduced by the amount, $30, which would have been treated as ordinary income if the stock had been sold by the decedent on the date of death). Consequently, the subsequent sale of the inherited DISC stock by B for $100 would (assuming no decrease in the DISC income attributable to such shares) generate $30 of ordinary income to B.

The rule provided by your committee has application whenever stock of a DISC (or former DISC) is included in the decedent's gross estate for Federal estate tax purposes. For example, if the DISC stock in the above example had been transferred by A to B in contemplation of death, the property would have been included in the decedent's gross estate and the basis in B's hands would be determined under the DISC rules in the same manner as if the stock had been acquired by B as a result of A's death.

Where the decedent's fiduciary elects the alternate valuation date for Federal estate tax purposes (pursuant to sec. 2032), in computing the gain which the decedent would have had if he had sold the DISC stock on the alternate valuation date, his basis is to be determined with reduction for any distributions which may have been made, after the date of the decedent's death and before the alternate valuation date, from the DISC's previously taxed income. By providing that the decedent's basis in the hypothetical sale is reduced by post-death distributions from previously taxed income, it is insured that the basis of the beneficiary will reflect the fact that a distribution has been made from previously taxed income during administration and prior to the alternate valuation date. For example, assume that A dies possessing DISC stock with a basis of $100, which stock is bequeathed to B. If the stock has a value of $110 on the alternate valuation date, its basis to B (assuming that the corporation has $50 of DISC income and $10 of previously taxed income) would be $100 ($110 less $10, the amount which would have been treated as ordinary income if the decedent had lived and sold the stock on the alternate valuation date). On the other hand, if a distribution of $10 had been made from previously taxed income prior to the alternate valuation date, B's basis would be $90 ($100, the fair market value of the stock on the alternate valuation date, less $10, the amount which would have been treated as ordinary income if the decedent had lived and sold the stock on the alternate valuation date).

15. Procedure and administration (sec. 504 of the bill and secs. 6011, 6072, 6501, and 6686 of the code)

The bill provides various reporting and recordkeeping procedures for the corporations which are or were DISC's. A DISC is to file a tax return for its taxable year on or before the 15th day of the 9th month following the close of the taxable year on such forms as are prescribed by the Treasury. A DISC or former DISC also must furnish for a taxable year such information to the Internal Revenue Service, and to any persons who were shareholders of the corporation at any time during the taxable year, as the Treasury requires by regulations. In addition, a DISC or former DISC must keep such records as are required by Treasury regulations.

Generally, the statute of limitations on the assessment of tax by the Internal Revenue Service against a corporation begins to run on the due date for the corporation's tax return (if the return is filed by that time). For purposes of applying this rule, the bill provides that if a corporation in good faith determines it is a DISC and files a DISC tax return for a taxable year, that tax return is to be considered as a regular corporate tax return. Thus, if the corporation subsequently is held not to be a DISC for the year, the filing of the DISC tax return will have started the statute of limitations running for purposes of assessments of tax against the corporation.

Penalties (which are in addition to the penalties provided in section 7203 regarding willful failures to file returns, supply information, or pay taxes) are provided for a failure to file a DISC tax return or to supply the information required under the bill. In the case of a failure to supply information, the penalty is to be $100 for each failure but the total penalty imposed for a calendar year with respect to failure to supply information may not exceed $25,000. In the case of a failure to file a DISC tax return, a penalty of $1,000 is imposed. These penalties, however, are not to apply in any case where the failure to supply information or file a DISC tax return is due to reasonable cause.

16. Export trade corporations (sec. 505 of the bill)

Under present law, a U.S. parent corporation of a controlled foreign subsidiary is subject to tax currently on the foreign subsidiary's subpart F income (generally its trading, etc., income). If the foreign subsidiary, however, derives its trading income from the sale of U.S. exports and invests that income in export trade assets, then the tax liability of the parent company on a subsidiary's income is deferred as long as it remains invested in the export trade assets. To a large extent, the export trade corporation provisions of present law serve the same objective which the DISC treatment provided by your committee's bill is designed to serve. Since there is a substantial overlap between these two sets of provisions, your committee believes it is appropriate to repeal the export trade corporation provisions of present law, and, in addition, to allow a parent corporation to transfer assets from its export trade corporation subsidiary to a DISC subsidiary without immediate tax consequences.

The bill provides that if a parent corporation directly owns all the outstanding stock of an export trade corporation and all the outstanding stock of a DISC, then no gain or loss or immediate income tax consequences are to result to any of the corporations involved, if the export trade corporation contributes property to the DISC in situations where two conditions are satisfied. First, the amount transferred to the DISC must be at least equal to the amount of the export trade corporation's untaxed subpart F income (i.e., the previously earned subpart F income on which tax has been deferred by virtue of export trade corporation treatment). Second, the transfer must occur during a taxable year beginning before January 1, 1976.

If the above described conditions are satisfied with respect to a transfer of property from an export trade corporation to a DISC, the bill provides that a series of adjustments are to be made with respect to the export trade corporation and the DISC to reflect the fact that the export trade corporation's tax deferred earnings have been transferred to the DISC. First, the earnings and profits of the DISC and its accumulated DISC income (i.e., its tax deferred income) are to be increased by the amount of any earnings and profits transferred to it (and the export trade corporation's earnings and profits are to be reduced by the same amount). This is to occur even if the amount transferred to the DISC is in excess of the export trade corporation's untaxed subpart F income, since the excess represents other untaxed foreign earnings. These amounts are to be treated as foreign source income when distributed by the DISC and the taxes paid by the export trade corporation on its earnings which are transferred to the DISC, in effect, are to be considered as paid by the DISC for purposes of determining the allowable deemed paid foreign tax credit which a corporate shareholder of the DISC is entitled to when it receives a dividend from the DISC.

Adjustments to the basis of the parent company's stock in the export trade corporation and the DISC also are provided by the bill so as to take account of the fact that all, or a portion, of the parent company's investment in its export trade corporation subsidiary has been transferred to its DISC subsidiary. It is provided that the basis of the parent's stock in the export trade corporation is to be reduced proportionately by the percentage of the export trade corporation's assets (measured by their adjusted basis) transferred to the DISC. For example, if 25 percent of an export trade corporation's assets were transferred to a DISC and the parent company's basis for its stock in the export trade corporation was $1 million, then that basis is to be reduced to $750,000. The amount by which the basis of the parent company's stock in its export trade corporation subsidiary is reduced is to be added to the basis of its stock in its DISC subsidiary.

In determining the amount of property transferred from an export trade corporation subsidiary to a DISC subsidiary, the bill provides that the amount transferred is to be the adjusted basis of the transferred property with proper adjustment being made for any indebtedness secured by the property or assumed by the DISC in connection with the transfer.

The rules discussed above apply in the situation where the parent company directly owns all of the stock of both its export trade corporation subsidiary and its DISC subsidiary. In situations where either the 100 percent ownership requirement is not met or the direct ownership requirement is not met, the bill provides that the rules discussed above are to be applicable to the extent, and in accordance with such rules, as the Secretary of the Treasury provides by regulations.

The bill also contains a provision which is designed to insure that accounts receivable, to the extent such receivables were export trade assets when held by the transferring export trade corporation, will be treated as qualified export assets in the hands of the DISC.

As indicated above, the export trade corporation provisions of present law are to be repealed for taxable years beginning after 1975.

It is possible that an export trade corporation at the time of the repeal will still have untaxed subpart F income. It may not have transferred its untaxed subpart F income by that time to a DISC under the rules discussed above. In such a case, it would appear that the corporation no longer intends to use the income in the export business and, accordingly, the bill provides that the corporation's untaxed subpart F income is to be taxed as if it had been ratably withdrawn from the export business over a 10-year period. In such a case, the amount of the former export trade corporation's untaxed subpart F income which it has at the end of its last taxable year to which the export trade corporation provisions apply (i.e., its last taxable year beginning before 1976) is to be ratably taxed to the shareholders of the corporation as subpart F income over the 10-year period beginning with its first taxable year after 1975. These amounts are to be included in the shareholders' gross income, whether or not the foreign corporation makes a minimum distribution election, in the same manner as would occur under present law if the untaxed income were withdrawn from investment in export trade assets.

17. Submission of annual reports to Congress (sec. 506 of the bill)

In order that the Congress may be apprised of the effects of the DISC treatment provided by the bill, it is provided that the Secretary of the Treasury is to submit an annual report to Congress setting forth an analysis of the operation and effect of the DISC system of taxation. Among other things, the report is to include an analysis of the revenue effects of the DISC system as well as its effects on the balance of trade of the United States.

These reports, which are to begin with the report for calendar year 1972, are to be submitted to the Congress within 15½ months following the close of each calendar year.

V. STATISTICAL APPENDIX

TABLE 1.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971, ELIMINATING THE PHASEOUT FROM THE 1971 MINIMUM STANDARD DEDUCTION[1] AND INCREASING THE 1971 EXEMPTION FROM $650 TO $675, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,555	170	20	$56
$3 to $5	9,460	95	230	227
$5 to $7	9,154	58	701	310
$7 to $10	13,316	2	317	223
$10 to $15	15,084			275
$15 to $20	6,334			135
$20 to $50	4,014			116
$50 to $100	398			20
$100 and over	99			5
Total	63,415	325	1,268	1,368

[1] Under present law the minimum standard deduction for 1971 is $1,050 "phased out" by reducing the additional allowance (difference between the 1969 minimum standard deduction and $1,050) by $1 for every $15 of adjusted gross income in excess of the 1971 nontaxable level; the Committee on Ways and Means has eliminated the phaseout thus making the minimum standard deduction a flat $1,050.

Note: Details may not add to totals because of rounding.

TABLE 2.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971, ELIMINATING THE PHASEOUT FROM THE 1971 MINIMUM STANDARD DEDUCTION[1], 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable[2] (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,407		20	$33
$3 to $5	7,622		230	160
$5 to $7	6,166		701	217
$7 to $10	2,814		317	33
$10 to $15				
$15 to $20				
$20 to $50				
$50 to $100				
$100 and over				
Total	22,008		1,268	443

[1] Under present law the minimum standard deduction for 1971 is $1,050 "phased out" by reducing the additional allowance (difference between the 1969 minimum standard deduction and $1,050) by $1 for every $15 of adjusted gross income in excess of the 1971 nontaxable level.

[2] A small but indeterminate number of returns are rendered nontaxable by this provision.

Note: Details may not add to totals because of rounding.

TABLE 3.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971, INCREASING THE 1971 EXEMPTION FROM $650 TO $675, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,555	170		$23
$3 to $5	9,460	95		67
$5 to $7	9,154	58		94
$7 to $10	13,316	2		190
$10 to $15	15,084			275
$15 to $20	6,334			135
$20 to $50	4,014			116
$50 to $100	398			20
$100 and over	99			5
Total	63,415	325		925

Note: Details may not add to totals because of rounding.

TABLE 4.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971, ADVANCING 1973'S 15 PERCENT STANDARD DEDUCTION AND $750 EXEMPTION TO 1972[1], 1971 INCOME LEVELS— BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,531	274		$45
$3 to $5	9,273	325		129
$5 to $7	9,069	201		187
$7 to $10	13,316	44	470	493
$10 to $15	15,084		657	689
$15 to $20	6,334			267
$20 to $50	4,014			231
$50 to $100	398			39
$100 and over	99			11
Total	63,117	844	1,127	2,091

[1] Thus changing 1972's $700 exemption to $750 and 1972's 14 percent standard deduction (with $2,000 ceiling) to 15 percent (with $2,000 ceiling).

Note: Details may not add to totals because of rounding.

TABLE 5.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971[1], ADVANCING 1973'S 15 PERCENT STANDARD DEDUCTION TO 1972, 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3				
$3 to $5	446			$3
$5 to $7	1,239			8
$7 to $10	7,657		470	123
$10 to $15	6,808		657	146
$15 to $20				
$20 to $50				
$50 to $100				
$100 and over				
Total	16,151		1,127	279

[1] Thus changing 1972's 14 percent standard deduction (with $2,000 ceiling) to 15 percent (with $2,000 ceiling).

Note: Details may not add to totals because of rounding.

TABLE 6.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971, ADVANCING 1973'S $750 EXEMPTION TO 1972[1], 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,531	274		$44
$3 to $5	9,273	325		126
$5 to $7	9,069	201		179
$7 to $10	13,316	44		370
$10 to $15	15,084			543
$15 to $20	6,334			267
$20 to $50	4,014			231
$50 to $100	398			39
$100 and over	99			11
Total	63,117	844		1,811

[1] Thus changing the exemption in 1972 from $700 to $750.

Note: Details may not add to totals because of rounding.

TABLE 7.—ESTIMATED EFFECT OF THE REVENUE ACT OF 1971, INCREASING THE MINIMUM STANDARD DEDUCTION TO $1,300, FOR CALENDAR 1972 AND THEREAFTER[1], 1971 INCOME LEVELS—BY ADJUSTED GROSS INCOME CLASS

Adjusted gross income class (thousands)	Number of returns benefiting (thousands)	Number of returns made nontaxable (thousands)	Number of returns shifting to standard deduction (thousands)	Decrease in tax liability (millions)
$0 to $3	5,174	1,500	141	$180
$3 to $5	7,770	366	577	358
$5 to $7	6,878	68	1,000	339
$7 to $10	5,132		446	115
$10 to $15				
$15 to $20				
$20 to $50				
$50 to $100				
$100 and over				
Total	24,954	1,933	2,164	992

[1] Thus increasing the minimum standard deduction in 1972 and thereafter from $1,000 to $1,300.

Note: Details may not add to totals because of rounding.

TABLE 8.—FEDERAL INDIVIDUAL INCOME TAX BURDEN[1] UNDER PRESENT LAW AND UNDER THE REVENUE ACT OF 1971, TAX LIABILITY, CALENDAR YEARS 1971, 1972, AND 1973 AND THEREAFTER

[Assuming deductible personal expenses of 10 percent of income]

Adjusted gross income (wages and salaries)	1971				1972				1973 and thereafter			
		Committee bill[2]				Committee bill[3]				Committee bill[4]		
			Tax decrease				Tax decrease				Tax decrease	
	Present law tax	Tax	Amount	Percent	Present law tax	Tax	Amount	Percent	Present law tax	Tax	Amount	Percent
Single person:												
$1,700[5]	0	0	0		0	0	0		0	0	0	
$1,725[6]	$4	0	$4	100.0	$4	0	$4	100 0	0	0	0	
$1,750[7]	7	$4	3	42.9	7	0	7	100.0	0	0	0	
$2,050[8]	52	46	6	11.5	49	0	49	100.0	$42	0	$42	100.0
$3,000	207	189	18	8.7	193	$138	55	28.5	185	$138	47	25.4
$3,500	296	272	24	8.1	276	217	59	21.4	268	217	51	19.0
$4,000	396	362	34	8.6	367	302	65	17.7	358	302	56	15.6
$5,000	599	552	47	7.8	557	491	66	11.8	548	491	57	10.4
$7,500	1,084	1,063	21	1.9	1,058	995	63	6.0	1,031	995	36	3.5
$10,000	1,603	1,596	7	.4	1,566	1,530	36	2.3	1,530	1,530	0	
$12,500	2,185	2,178	7	.3	2,104	2,059	45	2.1	2,059	2,059	0	
$15,000	2,877	2,869	8	.3	2,717	2,703	14	.5	2,703	2,703	0	
$17,500	3,551	3,543	8	.2	3,458	3,443	15	.4	3,443	3,443	0	
$20,000	4,289	4,281	8	.2	4,272	4,255	17	.4	4,255	4,255	0	
$25,000	5,933	5,924	9	.2	5,914	5,895	19	.3	5,895	5,895	0	
Married couple with no dependents:												
$2,350[9]	0	0	0		0	0	0		0	0	0	
$2,400[6, 10]	7	0	7	100.0	0	0	0		0	0	0	
$2,500[7]	22	14	8	36.4	14	0	14	100.0	0	0	0	
$2,800[8]	67	56	11	16.4	56	0	56	100.0	42	0	42	100.0

$3,000	97	84	13	13.4	84	28	56	66.7	70	28	42	60.0
$3,500	174	155	19	10.9	155	98	57	36.8	140	98	42	30.0
$4,000	254	230	24	9.4	230	170	60	26.1	215	170	45	20.9
$5,000	422	386	36	8.5	386	322	64	16.6	370	322	48	13.0
$7,500	853	829	24	2.8	820	753	67	8.2	786	753	33	4.2
$10,000	1,266	1,257	9	.7	1,228	1,190	38	3.1	1,190	1,190	0	
$12,500	1,754	1,743	11	.6	1,677	1,628	49	2.9	1,628	1,628	0	
$15,000	2,310	2,298	12	.5	2,172	2,150	22	1.0	2,150	2,150	0	
$17,500	2,873	2,860	13	.5	2,785	2,760	25	.9	2,760	2,760	0	
$20,000	3,456	3,442	14	.4	3,428	3,400	28	.8	3,400	3,400	0	
$25,000	4,764	4,748	16	.3	4,732	4,700	32	.7	4,700	4,700	0	
Married couple with 2 dependents:												
$3,650 [9]	0	0	0		0	0	0		0	0	0	
$3,750 [6]	15	0	15	100.0	0	0	0		0	0	0	
$3,800 [10]	22	7	15	68.2	0	0	0		0	0	0	
$4,000 [7]	52	35	17	32.7	28	0	28	100.0	0	0	0	
$4,300 [8]	97	77	20	20.6	70	0	70	100.0	42	0	42	100.0
$5,000	206	178	28	13.6	170	98	72	42.4	140	98	42	30.0
$7,500	607	578	29	4.8	561	484	77	13.7	514	484	30	5.8
$10,000	1,019	1,000	19	1.9	962	905	57	5.9	905	905	0	
$12,500	1,468	1,446	22	1.5	1,371	1,309	62	4.5	1,309	1,309	0	
$15,000	2,018	1,996	22	1.1	1,864	1,820	44	2.4	1,820	1,820	0	
$17,500	2,548	2,523	25	1.0	2,435	2,385	50	2.1	2,385	2,385	0	
$20,000	3,110	3,085	25	.8	3,060	3,010	50	1.6	3,010	3,010	0	
$25,000	4,352	4,324	28	.6	4,296	4,240	56	1.3	4,240	4,240	0	

1 These burdens have been computed without use of the optional tax table.
2 Eliminates the phaseout from the minimum standard deduction and increases the exemption from $650 to $675.
3 Advances 1973's 15 percent standard deduction and $750 exemption to 1972 and increases the minimum standard deduction from $1,000 to $1,300.
4 Increases the minimum standard deduction from $1,000 to $1,300.
5 Highest level at which there is no tax in 1971 and 1972 under present law.
6 Highest level at which there is no tax in 1971 under committee bill.
7 Highest level at which there is no tax in 1973 under present law.
8 Highest level at which there is no tax in 1972 and 1973 under committee bill.
9 Highest level at which there is no tax in 1971 under present law.
10 Highest level at which there is no tax in 1972 under present law.

TABLE 9.—FEDERAL INDIVIDUAL INCOME TAX BURDEN[1] UNDER PRESENT LAW AND UNDER THE REVENUE ACT OF 1971, TAX LIABILITY, CALENDAR YEARS 1971, 1972, AND 1973 AND THEREAFTER

[Assuming deductible personal expenses of 18 percent of income]

Adjusted gross income (wages and salaries)	1971				1972				1973 and thereafter			
		Committee bill[2]				Committee bill[3]				Committee bill[4]		
			Tax decrease				Tax decrease				Tax decrease	
	Present law tax	Tax	Amount	Percent	Present law tax	Tax	Amount	Percent	Present law tax	Tax	Amount	Percent
Single person:												
$1,700[5]	0	0	0	----------	0	0	0	----------	0	0	0	----------
$1,725[6]	$4	0	$4	100.0	$4	0	$4	100.0	0	0	0	----------
$1,750[7]	7	$4	3	42.9	7	0	7	100.0	0	0	0	----------
$2,050[8]	52	46	6	11.5	49	0	49	100.0	$42	0	$42	100.0
$3,000	207	189	18	8.7	193	$138	55	28.5	185	$138	47	25.4
$3,500	296	272	24	8.1	276	217	59	21.4	268	217	51	19.0
$4,000	396	362	34	8.6	367	302	65	17.7	358	302	56	15.6
$5,000	586	552	34	5.8	557	491	66	11.8	548	491	57	10.4
$7,500	1,005	1,000	5	.5	995	984	11	1.1	984	984	0	----------
$10,000	1,482	1,476	6	.4	1,470	1,458	12	.8	1,458	1,458	0	----------
$12,500	1,990	1,984	6	.3	1,978	1,965	13	.7	1,965	1,965	0	----------
$15,000	2,536	2,529	7	.3	2,522	2,509	13	.5	2,509	2,509	0	----------
$17,500	3,123	3,116	7	.2	3,109	3,094	15	.5	3,094	3,094	0	----------
$20,000	3,753	3,745	8	.2	3,737	3,722	15	.4	3,722	3,722	0	----------
$25,000	5,176	5,167	9	.2	5,158	5,140	18	.3	5,140	5,140	0	----------
Married couple with no dependents:												
$2,350[9]	0	0	0	----------	0	0	0	----------	0	0	0	----------
$2,400[6,10]	7	0	7	100.0	0	0	0	----------	0	0	0	----------
$2,500[7]	22	14	8	36.4	14	0	14	100.0	0	0	0	----------

$2,800[8]	67	56	11	16.4	56	0	56	100.0	42	0	42	100.0
$3,000	97	84	13	13.4	84	28	56	66.7	70	28	42	60.0
$3,500	174	155	19	10.9	155	98	57	36.8	140	98	42	30.0
$4,000	254	230	24	9.4	230	170	60	26.1	215	170	45	20.9
$5,000	418	386	32	7.7	386	322	64	16.6	370	322	48	13.0
$7,500	782	772	10	1.3	763	744	19	2.5	744	744	0	----------
$10,000	1,171	1,162	9	.8	1,152	1,133	19	1.6	1,133	1,133	0	----------
$12,500	1,589	1,578	11	.7	1,567	1,545	22	1.4	1,545	1,545	0	----------
$15,000	2,040	2,029	11	.5	2,018	1,996	22	1.1	1,996	1,996	0	----------
$17,500	2,523	2,510	13	.5	2,498	2,473	25	1.0	2,473	2,473	0	----------
$20,000	3,035	3,023	12	.4	3,010	2,985	25	.8	2,985	2,985	0	----------
$25,000	4,156	4,142	14	.3	4,128	4,100	28	.7	4,100	4,100	0	----------
Married couple with 2 dependents:												
$3,650[9]	0	0	0	----------	0	0	0	----------	0	0	0	----------
$3,750[6]	15	0	15	100.0	0	0	0	----------	0	0	0	----------
$3,800[10]	22	7	15	68.2	0	0	0	----------	0	0	0	----------
$4,000[7]	52	35	17	32.7	28	0	28	100.0	0	0	0	----------
$4,300[8]	97	77	20	20.6	70	0	70	100.0	42	0	42	100.0
$5,000	206	178	28	13.6	170	98	72	42.4	140	98	42	30.0
$7,500	544	527	17	3.1	510	476	34	6.7	476	476	0	----------
$10,000	924	905	19	2.1	886	848	38	4.3	848	848	0	----------
$12,500	1,314	1,295	19	1.4	1,276	1,238	38	3.0	1,238	1,238	0	----------
$15,000	1,754	1,732	22	1.3	1,710	1,666	44	2.6	1,666	1,666	0	----------
$17,500	2,205	2,183	22	1.0	2,161	2,117	44	2.0	2,117	2,117	0	----------
$20,000	2,710	2,685	25	.9	2,660	2,610	50	1.9	2,610	2,610	0	----------
$25,000	3,792	3,764	28	.7	3,736	3,680	56	1.5	3,680	3,680	0	----------

1 These burdens have been computed without use of the optional tax table.

2 Eliminates the phaseout from the minimum standard deduction and increases the exemption from $650 to $675.

3 Advances 1973's 15 percent standard deduction and $750 exemption to 1972 and increases the minimum standard deduction from $1,000 to $1,300.

4 Increases the minimum standard deduction from $1,000 to $1,300.

5 Highest level at which there is no tax in 1971 and 1972 under present law.

6 Highest level at which there is no tax in 1971 under committee bill.

7 Highest level at which there is no tax in 1973 under present law.

8 Highest level at which there is no tax in 1972 and 1973 under committee bill.

9 Highest level at which there is no tax in 1971 under present law.

10 Highest level at which there is no tax in 1972 under present law.

VI. EFFECT ON THE REVENUES OF THE BILL AND VOTE OF THE COMMITTEE IN REPORTING THE BILL

In compliance with clause 7 of rule XIII of the Rules of the House of Representatives, the following statement is made relative to the effect on the revenues of this bill. Your committee estimates that the bill will reduce tax liability by $1.7 billion in calendar year 1971, $7.8 billion in 1972, and $6.0 billion in 1973. The Treasury Department agrees with this statement. Part III of this report contains a more detailed statement of the revenue effect of the bill.

In compliance with clause 27(b) of rule XI of the Rules of the House of Representatives, the following statement is made relative to the record vote by the committee on the motion to report the bill. A total of 22 votes were cast for reporting the bill and a total of 2 votes were cast against reporting the bill.

DISSENTING VIEWS OF CONGRESSMAN CHARLES A. VANIK ON H.R. 10947

This tax proposal, including the establishment of the 7% investment credit, the repeal of the automobile excise tax and the Administration's Asset Depreciation Range, provide a tax reduction of over $5 billion to the business sector of the American economy, while the average taxpayer earning $9,000 per year with three dependents will receive a tax savings this year of only $24, or 7¢ per day. This legislation constitutes an incredible backward step in the struggle for tax justice. It is a sluggish, uncertain approach to recovery, full employment and stable prices.

The 7% investment credit will cost the Treasury $2.4 billion in fiscal 1972, while the Asset Depreciation Range will cost about $1.5 billion. The fiscal 1972 cost of DISC will be about $100 million. Since a considerable portion of the motor vehicle and light truck excise tax is on vehicles used in business, the net Treasury loss and business gain will exceed $5 billion in fiscal 1972. By fiscal 1977, this Treasury loss will reach an annual rate in excess of $12 to $15 billion.

For the next year the proposed tax credit appears more likely to increase corporate profits than to create jobs for unemployed workers. According to a New York *Times* survey, most companies will replace machinery and equipment at about the same rate they had planned before last month's windfall announcement. The survey indicated that few new jobs will be created quickly, either through plant expansion or in industries supplying new machinery.

If we calculate a $5 billion revenue loss in 1972 as the cost of creating 500,000 new jobs—a highly speculative figure—it would amount to over $10,000 in Treasury loss per job.

During Committee hearings, the testimony was overwhelming on the need for a tax break for every kind of business. There was an astonishing lack of expert testimony by objective, impartial economists—those who are motivated by principle—the love of nation over personal profit or reward.

The Committee considered the 7% investment credit as a permanent part of the tax law. There was no more evidence to support a 7% investment credit in 1971 than there was to support a 27½% depletion allowance in 1926. What is so holy and right about 7%? Why not 3%—or why not 14% on those purchases which are an increment over a base period? Why not a flat, five year depreciation on all machinery and equipment purchases? If we are writing a permanent law, why not establish some sustainable basis for our decision?

On April 22, 1969, the President, in urging repeal of the investment credit, said, "This subsidy to business investment no longer has priority over other pressing national needs." If he was right in April of 1969 in urging repeal of the investment credit, is he well-advised now to urge its reinstatement as a permanent law in addition to the Asset Depreciation Range System.

The repeal of the excise tax on automobiles and light trucks will cost the Treasury $2.6 billion in fiscal 1972 and $3 billion per year thereafter. In addition to business purchases, it only benefits the 7 million individual purchasers of automobiles who will now be expected to pay the straight sticker price for an overpriced automobile. The average automobile purchaser will soon catch on to this and return to his former practice of buying an automobile when he needs one, or when he gets a decent deal. In the meanwhile, the several states may impose excise taxes equivalent to or higher than 7%—and the Treasury loses $3 billion per year forever. Quite a cost for a little "ping" in the marketplace.

When budgetary limitations are finalized as a part of this economic package, $5 billion will have to come out of essential programs in health, job training, education, pollution control or welfare. In the alternative, the $5 billion must be packed onto the federal debt and fuel the inflation which trims the value of the dollar at home and abroad.

This tax program is designed to produce a vibrant bloom of corporate profits next summer and a harvest of bitter fruit in the cold seasons that follow. The tax package is inequitable and cruel to the individual taxpayer who will have to pay for it in the years ahead.

I must oppose this bill.

Charles A. Vanik.

DISSENTING VIEWS OF SAM M. GIBBONS

I strongly supported the President's August 15 action in imposing a temporary wage-price freeze to break the psychology of inflation which has plagued us for so long and in suspending the convertibility of the dollar into gold. These measures were long overdue and offered us a real opportunity to work out effective solutions to the problems of inflation, unemployment, economic stagnation and overvaluation of the dollar.

Unfortunately, I do not believe that the President's tax proposals—on balance and even in the modified form approved by the Committee—will really help to move us in the direction of solving these problems. Further, they will deprive us of billions of dollars in permanently lost Federal revenues. These revenues could be used much more constructively in other ways to solve our economic and social problems. In addition, their loss will further increase our rising national debt.

For these reasons, I urge that this bill be rejected and that we concentrate our energies on more effective means to solve our economic problems.

The Tax Package

Because our economic recovery is so important and also so basic to our ability to deal with the pressing social problems which confront us today, it was extremely disappointing to learn that the President's "new economic policy" tax proposals to stimulate consumer spending and job creation were so imbalanced and so ill suited to their task.

In many ways, these tax proposals represent both bad economic policy and bad social policy. They appear to reject completely the value of public spending on social needs as a stimulus to the economy—though government expenditures account for more than 20 percent of our gross national product—and place reliance for this on tax incentives of questionable effectiveness.

Further, they appear by their nature and magnitude rather unlikely to have a significant effect on unemployment, consumer spending or investment. They are costly in terms of Federal revenues lost—by some estimates, $70 billion in the next 10 years. They are highly favorable to business rather than the consumer, to some industries at the expense of others, and to the well-to-do rather than the average American. Finally, they are expected to result in a further increase in our rising national deficit, which is already more than $33.5 billion greater than it was at this time last year.

The Ways and Means Committee is to be commended for making some much needed changes in the President's tax package to stimulate the economy. However, other efforts in Committee to further improve the President's proposals were unsuccessful and the package retains much the same basic form—including the elements of ineffectiveness and inequity—which it had when it came to the Committee. For this reason, I do not believe that it can be justified, particularly in view of the billions of dollars in permanent loss of tax revenues which will eventually have to be made up by other American taxpayers.

What is really lacking in our economy, economists tell us, is a higher demand for goods and services, which is based on consumer and business confidence in the strength of our economy. This lack of demand is reflected in the present excess capacity in American industry averaging more than 25 percent. Unfortunately, the President's tax package offers little hope of significantly increasing this demand.

At a time when business and consumer confidence has been restored to some extent by the President's decisive action to curb inflation, I do not believe that we can afford to betray that confidence with a tax package which is anything less than equitable and effective in meeting our real economic needs. If this kind of tax package is not possible at this time, I would much rather see us rely on action such as an effective Phase Two anti-inflation program, additional job training and public service employment projects where needed, continuing progress on welfare reform and other pressing social issues, and revaluation of the dollar to help make our products more competitive in international trade.

Here are some of my detailed reasons for urging rejection of the tax package which is being recommended for approval by a majority of the members of the House Ways and Means Committee.

THE "JOB DEVELOPMENT CREDIT"

The Administration has put a new name on the old investment tax credit and has made it the key element of its tax program, claiming that it will not only result in increased capital investment and productivity in American industry but will also result in a significant increase in jobs available.

There is great uncertainty about the question of whether the investment tax credit will even result in expenditures for capital investment which would not have taken place anyway. Several recent surveys of business executives have shown that their present investment plans would be virtually unaffected by approval of the investment tax credit, since they are operating far below capacity and would want to see a real improvement in demand for their products before making new capital investments. It appears that this and other factors have a greater influence on capital investment decisions than does a tax incentive. Thus, even in this area it appears that we would be wiser to take direct steps to increase consumer demand, such as perhaps temporary tax cuts to individuals, than to provide tax breaks to business for capital investment which, in many cases, would have been made anyway.

The lack of agreement about the influence of an investment tax credit is reflected in the findings of a recent Brookings Institution conference on the use of this tax incentive in the decade of the 60's. A study by one prominent economist concluded that all business tax incentives, including the investment tax credit, accelerated depreciation, and reduced corporate income tax rates, generated only $2.8 billion in extra capital investment while costing the Treasury $8.6 million.

On the question of reinstating the investment tax credit at this time, one respected economist has predicted on the basis of an economic model that the President's entire economic program would increase business investment by only $2.4 billion while costing the Federal government more than $5 billion in lost reevnues.

Historically, when there has been a noticeable effect on the economy by an investment tax credit, the result has not necessarily been an increase in jobs or an increase in productivity or socially desirable products. The Administration has offered virtually no evidence that jobs will be created by an investment tax credit at this time. Indeed, most of the kinds of capital purchases which would be rewarded by this tax credit would *not* be the ones which would create jobs, although they might increase productivity.

Little immediate impact on investment and employment could be anticipated anyway under the investment tax credit. The Administration conceded that the time lag involved might be up to two years but proposed that this problem be overcome by setting the credit at an initial rate of 10 percent for one year and at a permanent rate of 5 percent thereafter. The Committee received little evidence to indicate that this would be true and concluded that a single rate of 7 percent should be established so that any surge of investment buying would not be followed by a period of little or no investment.

The reduction of our unemployment rate is basic to our economic recovery. It appears quite doubtful that an investment tax credit would have any significant effect on employment which could justify its being called a "job development credit." On this basis it appears that we must look elsewhere for remedies to the unemployment problem.

Like most of the rest of the President's tax package, the investment tax credit reflects the Administration's belief that our economy should be stimulated by tax benefits to business which will eventually "trickle down" to the consumer and the rest of the economy. The proposed tax credit, coupled with the Asset Depreciation Range (ADR) system of depreciation which the Administration put into effect earlier this year without Congressional authorization, would have meant more than $8.5 billion a year in tax breaks for business—about a 20 percent reduction in business taxes. There is little evidence that much of economic benefit of this substantial Federal revenue loss would ever have trickled down to the average American.

My own view is that if the investment tax credit were to be allowed at all during this time of scarce Federal revenue and pressing social needs it should be narrowed down to reduce its cost and focus its benefits on capital purchases which would actually increase the productivity of our industries rather than simply allowing a tax benefit for anyone who makes a capital purchase related to his business. I regret that my efforts in this regard were not successful. However, I am pleased that the Committee voted to allow a five-year write-off for the building or renovation of job training or child day care facilities. Expenditures for this purpose are directed at unmet needs in this country. There are of course many other such worthy causes which could be considered for tax benefits.

Finally, the "Buy American" provision of the proposed investment tax credit, which would remain in effect as long as the "temporary" 10 percent import surcharge remains, is clearly in violation of the intent of Section 3 of the General Agreements on Tariff and Trade (GATT). The Committee has authorized the President to suspend this and allow the tax credit for imported machinery, but only in certain very limited circumstances. This change does not eliminate the extremely undesirable effects of the "Buy American" provision on some American industries which use imported raw materials and on our relations with the other trading nations of the world. I shall have more to say about this in my comments below on the 10 percent surcharge.

The ADR System

Distressingly, The Asset Depreciation Range (ADR) system of depreciation which was put into effect by the Administration earlier this year without Congressional authorization is considered to be even less of an economic stimulus than the investment tax credit. Yet the Committee prohibited only one part of the ADR system—the provision allowing businesses an average of three-quarters rather than one-half of a years' depreciation for assets placed in service in a given year. Still remaining is a provision allowing taxpayers to use useful lives for equipment up to 20 percent shorter than their guideline lives for depreciation purposes. The Committee change in the ADR system will save an estimated $3.9 billion out of a total 1971–72 Federal revenue loss of $6.2 billion, but the cost of this tax break for business remains considerable.

The view of many economists who appeared before the Committee was that the combination of ADR and an investment tax credit was an unjustifiable tax bonanza for business. Therefore, it is disappointing that the Committee allowed the investment tax credit without at least suspending the questionable ADR sysem until it could be studied further by the Committee.

During the Committee's deliberation of the ADR system, it was defended by the Treasury as a means to close the estimated 10 percent gap in the "capital cost index" between the United States and trading competitors such as Japan and Germany. What Treasury officials neglected to note is that capital costs are responsible for only 20 percent of the cost of American manufactured products, with the rest accounted for by factors such as labor and transportation. Thus, ADR would improve the price competitiveness of American goods by only 2 percent but at a Federal revenue loss of $6.2 billion for 1971–72.

REPEAL OF THE AUTOMOBILE EXCISE TAX

The President requested repeal of the auto excise tax as a means to stimulate production and employment in the automobile and related industries. Repeal of the tax may provide this stimulus to some extent. Unfortunately, it would have the defect of concentrating benefits on one industry and one type of purchase—new cars. Also, it would encourage the production of a commodity which is not particularly high on our list of national priorities. The estimated cost of the proposal was $2.2 billion for fiscal 1972 alone. Because the Committee has extended repeal of the tax to include purchases of small trucks, the cost has risen to more than $2.5 billion for fiscal 1972.

There are now 110 million motor vehicles on our roads and highways. Particularly in our urban areas these cars and other vehicles present us with some significant social costs, including pollution, noise, traffic congestion, and land use for highways. In my own case, more cars on the road has meant an increase in my commuting time into Washington from 30 to 50 minutes, even though considerable Federal funds were spent to improve the roads I drive on.

We are making some progress in solving the problems caused by an overabundance of cars. However, there are good indications that we should be moving toward the development of more adequate public transportation facilities rather than buying more cars. Finally, repeal of the auto excise tax would discriminate against those who don't need a new car or can't afford one. Some kind of general tax reduction for individuals or tax credit for consumer purchases would seem much more appropriate. Just as we not long ago used a 10 percent surtax to reduce consumer buying power and combat inflation, we might now consider the use of a similar temporary tax *reduction* to increase disposable income.

INCOME TAX BENEFITS FOR CONSUMERS

I heartily agree with the Committee's action to increase disposable personal income by moving forward the effective date for the increases in personal income tax exemptions which were authorized by the Tax Reform Act of 1969. I also welcome the Committee's action in increasing the minimum standard deduction from $1050 to $1300 effective in 1972. In this area, my only regret is that any economic stimulus we might need could not be concentrated more in this type of tax benefit or in temporary income tax reductions for individuals.

DOMESTIC INTERNATIONAL SALES CORPORATION (DISC)

None of the arguments which I used against the DISC proposal in my dissenting views on the Trade Act of 1970 were met by the revived DISC proposal which was included in the President's tax package. DISC still represented an extremely complicated tax proposal which had every likelihood of rewarding the large corporations presently engaged in exporting without increasing our exports or helping small businesses to increase exports. Its cost was estimated at $600 million a year by the Treasury but others calculated that it would cost closer to $1 billion.

The Committee is to be commended for making some major improvements in the DISC proposal. First, the tax deferral for export earnings of a DISC was limited to 25 percent of the amount equal to the DISC's average earnings in the base period of 1968 through 1970 plus 100 percent of the incremental growth in export earnings since the base period. This at least goes toward meeting the objection that the DISC proposal is merely a tax benefit for exporters and not an incentive to increase exports.

Second, the Committee has taken action which would appear to correct another deficiency which I pointed out last year and again in the recent Committee hearings on the President's tax proposals. Namely, that DISC parent corporations could use their excess foreign tax credits attributable to other operations as an offset against DISC income. Thus, a U.S. exporter of coal who had unused foreign tax credits could not now run his profits from coal exports through a DISC and thereby avoid tax on these profits—as could have been done in the case of the original DISC proposal.

Nonetheless, DISC remains an extremely complex and costly unknown in the area of tax incentives. For 1972 its cost in Federal revenue losses has been estimated at $100 million. This figure would double for 1973.

Further, DISC is likely to be hard to administer and may even encourage unwarranted financial manipulations in order to give the appearance of increases in exports where there are none.

It is my understanding that the Administration is not pleased with the Committee's DISC proposal as a means to help American export businesses. Perhaps this fact will encourage further work on a proposal which will in fact help American exporters without involving all the defects of the original DISC proposal.

THE IMPLICATIONS OF THE 10-PERCENT IMPORT SURCHARGE

The President has consistently maintained that the 10 percent import surcharge which he imposed on August 15 would be "temporary." The original interpretation was that it would be used as a bargaining tool to help achieve a revaluation of the dollar with regard to currencies such as the yen, against which the dollar has been overvalued for some time now, and to thereby increase the price competitiveness of American exports and reduce the attractiveness of imports to American consumers. Recently, Administration spokesmen have indicated that they do not intend to lift the surcharge until the United States has achieved a $13 *billion* improvement in our balance of payments position.

It should be noted first of all that immediate action must be taken by the United States to achieve the revaluation of the dollar, which is so important to an improvement in our balance of trade and payments positions. The longer the import surcharge remains in effect, the less effective it will be as a bargaining tool for this purpose.

Also, there is general agreement among the economists who have appeared before various Congressional committees in recent weeks that the import surcharge must not be used as a hostage by which the United States will require the other countries of the world to assume the burden of our present trade and payments difficulties. These problems are rather recent and at least in part a result of our own failure to deal more effectively with our domestic inflation and productivity problems. They must be worked out in our domestic economy and by negotiation with the other major trading countries of the world. They must not be the subject of an ultimatum by the United States to the rest of the world.

It cannot be emphasized too strongly that the Administration, by its attitude on the surcharge and by measures such as the "Buy American" provision of the investment tax credit, runs the serious risk of incurring retaliation of other nations around the world—including those such as the European Common Market countries with whom we have a favorable balance of trade. Such action would be most harmful to Americans as consumers and to our substantial export trade. Further, it is not too much to say that it could lead to the kind of worldwide depressions and trade wars which plagued us in the not-too-distant past.

As many Members of Congress and others have indicated, a more balanced stance by the Administration on these vital international issues is imperative. In addition to the risks involved, the Administration's present stance does not appear to be very likely to be of much help in our efforts to negotiate equitable trading arrangements as a transition to freer trade, which will benefit us all. Further, injury to the developing nations in which we have invested so much aid since World War II will undoubtedly result from any movement toward a trade war.

PHASE TWO

The interrelated problems of combatting inflation, reducing unemployment, restoring confidence in the economy, and achieving a revaluation of the dollar are perhaps the most pressing economic issues facing us. If they can be resolved, it appears that we stand a very good chance of achieving economic recovery without such costly and inefficient instruments as the investment tax credit. For this reason, it is most important that the President's soon-to-be announcee Phase Two program be designed to inspire confidence in the economy, effectively hold down inflation, and provide equitably for only reasonable increases in prices, wages, salaries, interest rates and profits. If it does so and does not perpetuate the inequities of the present wage-price freeze, it will surely have solid Congressional and public support.

SUMMARY

Again, I regret that the Committee did not agree upon a more acceptable substitute for the President's tax program. However, since this was not done, I believe that our economic recovery and our general well-being will be served better by rejection of the President's tax program in its present form and by continuing action to curb inflation, combat unemployment, revalue the dollar, and deal with our unmet national needs.

For these reasons, I hope that my colleagues in the House will join me in voting to reject H.R. 10947 as it has been favorably reported by the Ways and Means Committee.

SAM GIBBONS.